

**ESTATE PLANNING WITH TOTAL RETURN  
TRUSTS: MEETING HUMAN NEEDS AND  
INVESTMENT GOALS  
THROUGH MODERN TRUST DESIGN**

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*Editors' Synopsis: The author discusses the use of total return trusts to balance the expectations of beneficiaries and the wishes of trustees. He details Proposed Treasury Regulations designed to facilitate the use of total return trusts to qualify for certain federal estate tax benefits, including the marital deduction, the charitable contributions deduction, and grandfathered status exempting pre-1986 trusts from the generation-skipping transfer tax. He then outlines and compares legislation that has been passed or proposed in several states recently to enable grantors to take maximum advantage of the Proposed Regulations should they become final. He discusses the results of several studies based upon computer modeling that suggest certain*

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*optimal distribution and asset mixes for total return trusts. Finally, he provides forms for proposed state legislation and various sample provisions for total return trusts tailored to meet specific estate planning goals.*

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## I. INTRODUCTION

Since the author's first article on "total return trusts"<sup>1</sup> in this journal in 1997<sup>2</sup> and William Hoisington's presentation at the Miami Institute in that same year,<sup>3</sup> much has been written in scholarly and professional journals about the concept of the "total return trust" and, specifically, about the total

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<sup>1</sup> A total return trust is a trust that allows the trustee to invest for total return and does not define distributions to the beneficiary in terms of accounting income.

<sup>2</sup> See Robert B. Wolf, *Defeating the Duty to Disappoint Equally—The Total Return Trust*, 32 REAL PROP. PROB. & TR. J. 45 (1997) (another version appeared in 23 ACTEC Notes 46 (1997)).

<sup>3</sup> See William L. Hoisington, *Modern Trust Design: New Paradigms for the 21st Century*, 5-5 (materials for Miami Institute, Jan. 1997).

return unitrust, or “TRU.”<sup>4</sup> Interest in total return trusts has gone beyond these professional publications into the mainstream financial press.<sup>5</sup> In

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<sup>4</sup> See, e.g., Mark B. Edwards, *Trusts for the New Century: The Third Paradigm*, THE WILL AND THE WAY (NCBA's Est. Plan. & Fiduciary Law Sec.), Nov. 1998, at 1; Graham D. Holding, Jr. & Christy E. Reid, *The Private Unitrust vs. The Discretionary Trust as a Paradigm for the New Century*, THE WILL AND THE WAY (NCBA's Est. Plan & Fiduciary Law Section), Feb. 1999, at 1; James Dam, *Should Estate Planners Be Revising Their Trusts*, 2000 LWUSA 101 (Feb. 7, 2000); David A. Diamond, *Trust Design and Investment Strategy for the Next Millennium: Pulling the Plug on Income Rule Trusts*, CAL. TR. AND EST. Q., No. 3, Fall 1999 at 12; James Garland, *The Problem With Unitrusts*, J. OF PRIVATE PORTFOLIO MGMT., Spring 1999 at 35; James Garland, *A Market-Yield Spending Rule Revisited: Update Through 1998*, J. OF PRIVATE PORTFOLIO MGMT., Winter, 1999; Jerold I. Horn, *Prudent Investor Rule, Modern Portfolio Theory, and Private Trusts: Drafting and Administration Including the “Give-Me-Five” Unitrust*, 33 REAL PROP. PROB. & TR. J. 1 (1998); Arthur M. Sherwood, *Tax Aspects of Using a Unitrust Amount to Define Appropriate Benefit Currently Distributable from Non-Charitable Trusts*, N.Y. ST. B. J., September/October 1998, at 70; Robert J. Rosepink, *The Total Return Trust—Where and How to Tax Capital Gains*, TR. & EST., October 1998, at 12; Robert B. Wolf, *Total Return Trusts—Can Your Clients Afford Anything Less?*, 33 REAL PROP. PROB. & TR. J. 131 (1998) (another version appeared in 24 ACTEC NOTES 45 (1998)); William L. Hoisington, *Fiduciary Principles, Modern Financial Theory and Practical Implications for Trust Design and Administration*, ACTEC 1998 ANN. MEETING SYMP. (1998) at S-2-WLH; James W. Rockwell, *Total Return Trusts*, 26th Ann. Prob. & Tr. L. Conf., Minn. B. Assn., June 2, 2000, at 1; Jonathan A. Levy, *The Total Return Unitrust: Is It Time for High-Fives?*, TR. & EST., June 2000, at 42; Bruce A. Guiot & Robert B. Wolf, *Case Study—Total Return Trusts: Techniques and Applications*, 34TH ANN. PHILIP E. HECKERLING INST. ON EST. PLAN. (Jan. 2000) at II-A-1; Robert B. Wolf, Stephen R. Leimberg & Susan Porter, *The Total Return Trust (TRU) Revolution—An Introduction*, 34TH ANN. PHILIP E. HECKERLING INST. ON EST. PLAN. (Jan. 2000) at I-C-1; Michel W. Nelson, *In Support of a Unitrust Distribution Concept*, 127th Ann. Convention, Iowa St. B. Assn., June 22, 2000 at 1; Robert B. Wolf & Stephen R. Leimberg, *Total Return Unitrust: The (TRU) Shape of Things to Come*, RES. INST. OF AM., EST. PLANNER'S ALERT, Dec. 1998, at 6; Robert B. Wolf & Stephen R. Leimberg, *The Latest Legislation Governing Total Return Unitrusts*, 28 EST. PLAN. 474 (2001); audio tape with printed source materials: Stephen R. Leimberg, *The Total Return Unitrust: What's New in Light of Proposed Reg-106513-00 and Developments in Various State Laws*, KEEPING CURRENT, Sept. 2000 (Soc. of Fin. Serv. Profs.)

<sup>5</sup> See *A Welcome New Twist in Trusts*, STANDARD & POOR'S OUTLOOK, Feb. 10, 1999, at 8-9; Brad Burg, *Will Your Trusts Keep Your Heirs Poor—and Fighting?*,

addition, these new forms of trusts have gained favor with planners and investment professionals. The pace of change is accelerating everywhere, including legislative changes, and the issuance by the Treasury Department (“Treasury”) of highly favorable Proposed Regulations. These developments appear to ensure that the pace of change will quicken markedly over the coming months and years. This momentum requires a closer examination of the new trust techniques and designs which address specific estate planning scenarios that could not have been addressed using the conventional models. This Article will illustrate these techniques and the dramatic differences they can make with case studies and with the benefit of the author’s computer modeling program.

The author’s first article made the case that the traditional trust, which directs the trustee to hold the principal and pay the income to the current beneficiary (the “income rule trust”) causes needless conflicts between the trustee and the beneficiaries and between the current beneficiary and the remainder beneficiary.<sup>6</sup> The trust world, which still distinguishes between accounting income and principal, is out of step with the investment world, which focuses on total return, whether created by interest, dividends, or growth.<sup>7</sup> What is more surprising is that within the charitable field, the management of charitable endowments long ago threw off the chains of income and principal and embraced other forms of “spending rules” to determine what could be spent from an endowment fund on a current basis while still affording the fund the advantages of total

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MED. ECON., Sept. 18, 2000, at 63; Carrie Coolidge, *In Growth We Trust*, FORBES, Mar. 8, 1999, at 166; Frank Croke, *Total Chaos*, FIN.PLAN., May 2000, at 95; Ashlea Eberling, *New Cash from Old Trusts*, FORBES, Sept. 17, 2001, at 144; Michael L. M. Jordan, *Implementing MPT In an Allocated Total Return Trust*, J. OF FIN. PLAN., June 1998, at 78; Lynn O’Shaughnessy, *Seven Trust Trip-Ups*, MUTUALFUNDS, June 2000, at 88; Barbara Gilder Quint, *How a Unitrust Could Keep the Whole Family Happy*, 17 PHYSICIANS FIN. NEWS, Apr. 15, 1999, at 8, available at <http://pediatrics.medscape.com/PFNPublishing/PhysiciansFinancialNews/1999/v17.n5/pfn1705.08.01.html> (last visited Jun. 26, 2001); Dan Rottenberg, *Wealth Preservation Liberated Trust*, BLOOMBERG PERS. FIN., 1998, at 101.

<sup>6</sup> See Wolf, *supra* note 2, at 49-52.

<sup>7</sup> See *id.* at 52-60.

return investing.<sup>8</sup> One can only surmise why these developments came about so much earlier in the charitable field than in the private trust field, but the answer to this seems as close to our hearts as the Internal Revenue Code. Charitable endowments, for the most part, are not constrained by taxes, but taxes have preoccupied estate planners to the extent that we have just now started to catch up with the non-profit and charitable sectors. The crescendo of interest in total return trusts occurs at a time when the federal estate tax are scheduled for a gradual reduction, then elimination in 2010 and resuscitation in 2011 under the Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”).<sup>9</sup> While the author sincerely doubts that the elimination will occur, it nevertheless *might* occur. It is, after all, on the books now, even though that course is almost certain to change in the future. It is highly likely, however, that the importance of the federal estate tax will *decline* for many of our clients, as the applicable credit amount increases to \$1,000,000 in 2002, \$1,500,000 in 2004 and \$2,000,000 in 2006. This much of the package seems highly likely to stay in place, in light of the earlier Democratic proposals to go at least that far.<sup>10</sup> Perhaps estate planners will now focus more attention on designing trusts to maximize returns and satisfy the human needs of their clients and their clients’ families.

The author’s second article on total return trusts factored into the analysis the real world costs of trustees’ fees, taxes, and turnover, and examined how each of these factors, and all of them in combination, make

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<sup>8</sup> See *id.* at 60-62. See also Joel C. Dobris, *Real Return, Modern Portfolio Theory, and College, University, and Foundation Decisions on Annual Spending from Endowments: A Visit to the World of Spending Rules*, 28 REAL PROP. PROB. & TR.J. 49 (1993) (examining the investment practices of colleges and universities to show their investment policy is based on total return rather than traditional income allocation).

<sup>9</sup> Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16, § 511, 115 Stat. 38, 70 (2001).

<sup>10</sup> Democrat Rangel had offered an alternative to H.R. 8 that would have increased the applicable credit amount to \$2,000,000 (\$4,000,000 for married couples) effective January 1, 2001 phasing to \$2,500,000 for individuals (\$5,000,000 for married couples) by 2010. Lloyd Leva Plaine & Wendy Ann Wilkenfeld, *Preliminary Consideration of Gift, Estate and Generation-Skipping Transfer Tax Planning Issues after Enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001*, 27 ACTEC JOURNAL 119, 119 n.1 (2001).

the job of providing an adequate return for the current beneficiary and a reasonable prospect of preserving the real value of the trust corpus for the future beneficiaries a daunting task.<sup>11</sup> By computer modeling trust portfolios in a variety of different markets, with different payout rates and investment mixes, the author confirmed in the trust context the critical nature of asset allocation and the irrelevance of accounting income when deciding upon an asset allocation between stocks and bonds.<sup>12</sup> A high yielding portfolio with a preponderance of bond investments can, in fact, afford to pay out very little to the current beneficiary, if the goal is to maintain the real value of the trust portfolio after taxes, expenses, and inflation.<sup>13</sup> A lower yielding, equity rich portfolio may be in a far better position to pay out more to the current beneficiary, while preserving the value of the trust, because the overwhelming majority of return from most stocks today is their growth in value, not their dividend yield.<sup>14</sup>

As a result of the author's extensive computer modeling of unitrust payouts, the author has concluded that a unitrust rate of three to five percent provides a reasonable opportunity for the trust over the long run to maintain its current value after the effects of taxes, expenses, and inflation, assuming the trust has invested the majority of its assets in equities.<sup>15</sup> The author's analysis critically assumes in this connection that by virtue of the provisions of the trust instrument and pursuant to state law, capital gains incurred can be taxed to the current beneficiary to the extent that he or she receives a unitrust distribution in excess of the trust's accounting income. Fortunately, the Internal Revenue Service ("Service") recently issued Proposed Regulations giving effect to just such an ordering rule when provided by state law or the governing instrument.<sup>16</sup> Those regulations

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<sup>11</sup> See Wolf, *supra* note 4, at 154-59.

<sup>12</sup> See *id.* at 166-78.

<sup>13</sup> See *id.* at 167 (focusing on Graph 2).

<sup>14</sup> Even after the substantial sell off in the markets over the past year, the yield on the S & P 500 is still only 1.53 percent as of October 1, 2001. See Steve Leimberg & Bob LeClair, FAXNET NEWSL. Oct. 1, 2001, at 1. The S&P 500 would have to decline 69.4 percent from its current level to push the dividend yield back up to five percent. *Id.*

<sup>15</sup> See Wolf, *supra* note 4, at 166-79.

<sup>16</sup> See Definition of Income for Trust Purposes, Prop. Treas. Reg. § 106513-00, 66 Fed. Reg. 10396-10402 (Feb. 15, 2001).

confirm that a unitrust payout of three to five percent represents a reasonable allocation of total return between the current and remainder beneficiaries.<sup>17</sup>

## II. STATE LAW—THE ENGINE OF CHANGE

As described in detail in the author's previous articles, two of the chief engines of change in the trust area are the Uniform Prudent Investor Act ("UPIA")<sup>18</sup> and the Uniform Principal and Income Act ("UPAIA"),<sup>19</sup> each of which is gradually working its way across the country. The UPIA has been adopted by the District of Columbia and thirty-five states<sup>20</sup> and the UPAIA has been adopted in the District of Columbia and twenty-four states.<sup>21</sup> Section 104 of the UPAIA allows a trustee to make adjustments between income and principal if the trustee, after considering all of the relevant factors, is unable to administer the trust impartially with respect to the current and remainder beneficiaries.<sup>22</sup> The author's prior article should be consulted for a detailed description of Section 104 and its advantages and limitations.<sup>23</sup> A growing number of states are adopting a dual approach to the conflict between income and total return: the UPAIA's Section 104 "power to adjust" and the private unitrust, which would pay out a percentage of the fair market value of the trust, generally averaged over a

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<sup>17</sup> *Id.*

<sup>18</sup> *See* UNIF. PRUDENT INVESTOR ACT, 7B U.L.A. 280 (2000).

<sup>19</sup> *See* UNIF. PRINCIPAL AND INCOME ACT, 7B U.L.A. 131 (2000).

<sup>20</sup> *See* Fact Sheets at website for National Conference of Commissioners on Uniform State Laws available at [www.nccusl.org/uniformact\\_factsheets/uniformacts-fs-upria.htm](http://www.nccusl.org/uniformact_factsheets/uniformacts-fs-upria.htm) (listing the thirty-six states and the District of Columbia that have adopted the UPIA).

<sup>21</sup> *See id.* available at [www.nccusl.org/uniformact\\_factsheets/uniformacts-fs-upia.htm](http://www.nccusl.org/uniformact_factsheets/uniformacts-fs-upia.htm). (Alabama, Arizona, Arkansas, California, Colorado, Connecticut, District of Columbia, Hawaii, Iowa (without section 104), Kansas, Maryland, Minnesota, Missouri (with a unitrust alternative), Nebraska, New Jersey (with a unitrust safe harbor), New Mexico, New York (with a unitrust alternative), North Dakota, Oklahoma, South Carolina, Tennessee, Virginia, and West Virginia, and Wyoming have all adopted the UPAIA, with introductions in five more states so far this year).

<sup>22</sup> Wolf, *supra* note 4, at 140-42.

<sup>23</sup> *Id.*

three year period to smooth the distributions to the beneficiary.

A. The New York Turns the Key

As discussed previously, the real problem is that our traditional definition of income *doesn't work anymore* in the context of stocks and bonds. New York was the first state to take up the task of a serious analysis of the "income" problem and propose a change. While it was the fourth state to enact unitrust friendly legislation on September 4, 2001,<sup>24</sup> the work of its legislative committees produced much of the early initiative and progress in legislative analysis.

With the issuance of its fifth report dated May 11, 1999, New York's Statewide Legislative Advisory Committee proposed the adoption of a version of the new Uniform Principal and Income Act for existing trusts, including Section 104 discussed above.<sup>25</sup> Perhaps even more significantly, the Committee proposed a new default standard for future trusts which redefined accounting income for new trusts and estates as a four percent unitrust interest, including the three-year smoothing rule suggested in this author's prior articles and as discussed in the following section of this Article.<sup>26</sup> New York's unique approach would allow the drafter to opt into the new default rule or into Section 104. The Report recommended this section be placed in the Prudent Investor Act rather than the Uniform Principal and Income Act because it grows out of investment principles and from New York's provision that the trustee ought to invest in such a way as to provide an "appropriate benefit currently distributable."<sup>27</sup> While the Committee recommended the adoption of the new Uniform Principal and Income Act along with Section 104, it clearly concluded that the principal and income standard was fundamentally

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<sup>24</sup> The final Bill was passed by the New York Assembly on June 18th, and by the Senate on June 19th, but was not delivered to the Governor until August 23, 2001. <http://assembly.state.ny.us/leg/?bn=A09050>.

<sup>25</sup> STATE OF N.Y., EPTL-SCPA LEGIS. A DV. COMM., PROPOSED CHANGES TO THE DEFINITION OF TRUST ACCOUNTING INCOME, TO REDEFINE A PPROPRIATE BENEFIT CURRENTLY DISTRIBUTABLE, May 11, 1999 (on file with author).

<sup>26</sup> *Id.* Exhibit 1, at 6-12.

<sup>27</sup> *Id.* Exhibit 2(A), at 1.

flawed:

Section 104 of the Revised Uniform Act provides an adjustment power as between principal and income based on a trustee's determination that the application of the Act would otherwise fail to provide an appropriate benefit. Thus, the Act itself recognizes that it may be flawed in achieving its intended purpose. Its final application depends on a trustee's judgment as to what would be impartial. Alternatively, it would be possible to have a principal and income act which abandoned mechanical definitions of income and gave the trustee power to allocate to income whatever was considered impartial. Neither the Revised Uniform Act nor such an alternative approach, ultimately provide an adequate standard for trustees of future trusts to apply. In the Committee's view, the law should be rewritten to face the real issue more directly and to provide more guidance to trustees in defining appropriate benefit currently distributable.<sup>28</sup>

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

The level of income is manipulable because it depends on investment choice. One company may pay profits as dividends to shareholders and another company may retain its profits, increasing stock value.<sup>29</sup>

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Longer term bonds have an "inflation premium" built into the interest they must pay to attract purchasers. To distribute this premium entirely to a current beneficiary

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<sup>28</sup> *Id.* Exhibit 1, at 3.

<sup>29</sup> *Id.*

sacrifices the long term purchasing power of principal.<sup>30</sup>

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

The proposal allowed both existing trusts and future trusts the ability to opt in or out of either a unitrust or the new Uniform Principal and Income Act regimen including the flexibility of Section 104. As originally recommended, existing trusts would have been governed by the new UPAIA with Section 104, but with the option of electing the unitrust approach. Future trusts would have been within the unitrust regimen with the option to change back to the UPAIA with Section 104.<sup>31</sup> As a result of suggestions and comments by the New York Bankers' Association, the New York State Bar Association Trusts and Estates Law Section and others, the unitrust regimen was made an option for both existing trusts and future trusts with the UPAIA and Section 104 as the default in both cases.<sup>32</sup> The final version which was enacted makes the standard for marital trusts the income or unitrust amount whichever is the greater, thereby avoiding the question of whether a four percent unitrust interest would qualify for the marital deduction.<sup>33</sup>

These changes will require trustees to address these issues and decide which course appears most suitable for their specific trust. The

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<sup>30</sup> *Id.* at 4.

<sup>31</sup> *Id.*, Exhibit 2(C).

<sup>32</sup> STATE OF N.Y., EPTL-SCPA LEGIS. ADVI. COMM., PROPOSED CHANGES TO THE DEFINITION OF TRUST ACCOUNTING INCOME, TO REDEFINE APPROPRIATE BENEFIT CURRENTLY DISTRIBUTABLE, (Supp. to 5th Rep., May 26, 2000) (on file with author). Concerns were expressed by several affected groups, including the Association of the Bar of the City of New York, as to which regimen should be used as the default standard, some preferring the UPAIA and Section 104. Concerns also were expressed as to the use of the unitrust regimen during the estate administration prior to funding of a trust. This was viewed by some as unduly complicated and was also eliminated in the final version.

<sup>33</sup> The Committee had submitted a letter of inquiry to the Service relative to its view on the matter. Guidance on this and other issues was forthcoming and is discussed in Section III of this article.

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

Importantly, this New York Committee requested the Service by letter dated December 30, 1999 to address the tax implications of these prospective changes in the state law definition of income particularly with reference to the marital deduction. This request for guidance along with several other issues raised by the author's articles<sup>34</sup> was answered in the Proposed Regulations discussed in the next section of these materials.

#### B. Delaware First to Enact Total Return Unitrust Statute!

On June 21, 2001, Delaware became the first state in the country to enact a statute expressly allowing trustees of income trusts to convert their regime to one employing the TRU concept. While both New York, which passed its statute the day before, and Missouri, which passed its statute at the end of May were ready to put their laws into effect, Delaware's Governor held the quickest pen.<sup>35</sup>

Delaware's statute allows a trustee to convert an income trust to a unitrust or a unitrust to an income trust, by giving proper notice to the current and remainder beneficiaries. If no one objects within a sixty day

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<sup>34</sup> Wolf, *supra* n. 4 at 153 (ordering rule for capital gains as a part of DNI); Wolf et al, *supra* n. 4 at I-C-47-I-C-48; Wolf et al, *supra* n. 4 at I-C-90 (effect of modification of income rule trust to unitrust on GST grandfathering).

<sup>35</sup> <http://www.legis.state.de.us/>. The Act amends Title 12 of the Delaware Code, by adding a new § 3527 entitled "Total return unitrusts."

period after the notice, the change can be made with no court involvement.<sup>36</sup> Even if there are no disinterested trustees, the statute provides a secure mechanism to appoint a disinterested person to make the decision about the conversion, so that court involvement should only rarely be necessary (famous last words perhaps).<sup>37</sup>

A unique feature of the Delaware statute is that the trustee has a choice to set the rate between three and five percent (this range probably was taken from the range noted as acceptable in the Proposed Regulations as discussed in Section III of this article).

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

- (1) the intentions of the trustor, as reflected in the governing instrument,
- (2) general economic conditions,
- (3) projected current earnings and appreciation for the trust, and
- (4) projected inflation and its impact on the trust.<sup>38</sup>

The trustee has discretion to determine the effective date of the conversion, the timing of distributions, and the valuation dates or the averages of valuations dates as are deemed appropriate.<sup>39</sup>

The Delaware law specifically grants the trustee the power to allocate short and long term capital gains to income for purposes of determining distributable net income ("DNI").<sup>40</sup> As discussed later in connection with the new Proposed Regulations, this is important because it may lower the total tax burden, but more importantly, it makes a higher

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<sup>36</sup> DEL. CODE ANN. tit 12, § 3527(b)(2) (2001).

<sup>37</sup> DEL. CODE ANN § 3527(c)(2001).

<sup>38</sup> DEL. CODE ANN § 3527(f)(2001).

<sup>39</sup> DEL. CODE ANN § 3527(i)(2001).

<sup>40</sup> DEL. CODE ANN § 3527(h)(2)(2001).

payout rate prudent. Delaware's unitrust statute gives the trustee significant flexibility in administering new total return unitrusts, particularly the flexibility of choosing a unitrust rate between three and five percent. This is favorable, provided that the trustees do not mind making some important choices in the process.

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

C. Missouri shows TRU Grit in Following Dual Unitrust/Power to Adjust Approach.

Missouri, like New York, enacted a statute with both the unitrust and the power to adjust and was the second state to enact unitrust legislation on July 7, 2001.<sup>41</sup> The power to adjust and the unitrust sections are protected by short statutes of limitations, so that after a two year period from the action of an adjustment<sup>42</sup> or three years after a unitrust conversion,<sup>43</sup> the action becomes incontestable. The unitrust portion of the statute provides for the three year smoothing rule as recommended in this and the author's prior articles.<sup>44</sup>

The unitrust statute will apply to any trust referring to the new statute created after August 28, 2001, and to any irrevocable trust created before that date, if the trustee elects to have the section apply, but the election requires notice to all qualified beneficiaries of the trust and the settlor, if living, and would not go into effect until two years later—August 28, 2003.<sup>45</sup> This two-year delay may be distinctly less helpful to trustees desiring change.

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<sup>41</sup> <http://www.house.state.mo.us/bills01/bills01/hb241.htm>.

<sup>42</sup> MO. REV. STAT. § 469.409 (2001).

<sup>43</sup> MO. REV. STAT. § 469.411.5.(3) (2001).

<sup>44</sup> MO. REV. STAT. § 469.411.1.(1)-(2) (2001).

<sup>45</sup> MO. REV. STAT. § 469.411.5 (2001).

Perhaps the most interesting (and perhaps problematic) aspect of the otherwise thoughtfully drafted Missouri statute is that the unitrust percentage must be at least three percent,<sup>46</sup> but it has no upper limit. Nor is there any ordering provision or express power in the trustee to allocate short and long-term capital gain to the unitrust amount. This is important in that without such an ordering provision or consistently applied trustees' practice, a given rate will have the effect of a higher stated rate compared to the same rate used in a state in which the law includes an ordering provision.

The lack of any stated cap or limit on the unitrust rate may well encourage beneficiaries to make unreasonable demands of Missouri's trustees, since in the eyes of an "average" beneficiary, five percent or even ten percent may not sound like an unreasonable request for the unitrust rate. Perhaps it is no coincidence that under the Missouri statute, only the trustee is empowered to make the conversion, and choose the rate. It will be interesting to observe the experience of trustees who have been given such discretion to see what pressures will be brought to bear on them in regard to its exercise. Of course those pressures could potentially be even greater with the power to adjust, which does not have any explicit upper or lower limit.

#### D. New Jersey's "Semi-Safe Harbor" Approach

Unlike Delaware, New York, and Missouri, New Jersey's approach to allow a unitrust methodology was to grant the trustee safe harbor for the use of the power to adjust under its new Uniform Principal and Income Act.<sup>47</sup> The applicable language is terse:

A decision by a trustee to increase the distribution to the income beneficiary or beneficiaries in any accounting period to an amount not in excess of four percent, or to decrease that period's distributions to not less than six percent, of the net fair market value of the trust assets on the first business day of that accounting

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<sup>46</sup> MO. REV. STAT. § 469.411.1.(1) (2001).

<sup>47</sup> N.J. STAT. ANN. § 3B:19B-4 (2001).

period shall be presumed to be fair and reasonable to all of the beneficiaries. Any adjustment by a trustee between income and principal with respect to any accounting period shall be made during that accounting period or within 65 days after the end of that period.<sup>48</sup> (Emphasis added)

Note that all that the statute does is create a presumption that the adjustment is fair and reasonable to all of the beneficiaries. It does not definitely safe harbor such an adjustment. In effect, it gives guidance as to a range of adjustments upward to four percent, or downward to six percent, which are thought to be *prima facie* reasonable.

The adjustment is not a true safe harbor, because it is only presumed to be fair and reasonable. It is not conclusively presumed to be fair and reasonable. For this reason one might consider the statute to be a “semi-safe harbor” approach. Of course the high-end safe harbor allowing a trustee to adjust income downward to not less than six percent appears irrelevant for the moment. Unfortunately too, if one were to invest 100 percent in bonds today (or better yet, in March of 2000) it is unlikely that any adjustment could be made because the income from an all bond portfolio is unlikely to be in excess of six percent. And a trustee may not feel safe adjusting between four percent and six percent because of the statutory presumption.

Thus by giving guidance that it is reasonable for a trustee to adjust income up to four percent or down to six percent, the provision is likely to discourage adjustments of income when the traditional accounting income otherwise would be between four percent and six percent, perhaps on the theory that four percent to six percent is a reasonable range for income from a trust. While most beneficiaries might well agree with the reasonableness of that range of income, in reality it is too high. Unfortunately, also, this level of traditional accounting income is unlikely to occur unless the portfolio is largely or completely in bonds such a choice of investment may result in no return left in the trust for the remainder beneficiary, causing the trustee to fail to fulfill its duty of impartiality.

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<sup>48</sup> *Id.*

From a tax point of view this approach also may be less favorable. It is not clear that this approach will attract the same imprimatur from the Proposed and Final Regulations as the separate statutory unitrust regimes adopted in New York, Delaware, and Missouri, and as proposed for Pennsylvania as discussed below. Clearly the New Jersey statute should allow an income rule trust to retain the tax identity of its “income” despite the existence of the power to adjust, though six percent is above the range mentioned in the Proposed Regulations. But what will the New Jersey statute do for trusts that are drafted as unitrusts to begin with? Will a five percent unitrust in a marital trust qualify for the marital deduction, if the trustee is not required to pay out all of the income if it is greater than the five percent? That seems unlikely. And what about a conversion from an income rule trust to a unitrust—is that going to be permissible for GST purposes? These questions do not have clear answers in New Jersey as they do in states that have used the dual approach, making the power to adjust and the unitrust both expressly available, or in states that adopt the Delaware approach of a unitrust with an express choice of rate between three percent and five percent.

While a safe harbor approach sounds reasonable, states considering such an approach should consider carefully all of the effects of a semi-hybrid approach. A safe harbor approach may well take away the best characteristics of both the power to adjust and the unitrust. It will detract from the flexibility of the power to adjust, and will detract from the predictability of the unitrust. Perhaps just as important, it is unlikely to secure the full tax benefits of a redefinition of income in unitrust terms for new trusts that are drafted as unitrusts.

E. Pennsylvania Enters the Discussion With a Unitrust/Power to Adjust Statutory Proposal.

On the same day that Delaware’s total return unitrust statute became law, Pennsylvania Senate Bill 1014 was introduced (perhaps numbered wistfully to help take our minds off of the scheduled loss of our beloved step-up some years down the road). Pennsylvania’s Bill, like New York’s, adopts a default rate of four percent, but references specifically the right to adopt a different rate by court action (although most of the actions

and decisions contemplated under the Pennsylvania Bill would not require court action).

The Pennsylvania Bill gives the trustee the ability to choose between the power to adjust and a statutory unitrust, in which case the power to adjust is expressly waived. The power to adjust and the unitrust statute are intended to be very broadly available in the Pennsylvania proposal, as the requirement that the trustee be acting as a prudent investor, contained in the uniform act was omitted as being unduly restrictive.<sup>49</sup> Tax sensitive situations are excluded from the application of either of the two approaches, and in case of doubt, the power to adjust or the power to convert to a unitrust may be released, either permanently or for a specified period of time.

Pennsylvania's statutory unitrust option allows the trustee to convert an existing trust to a four percent unitrust by a simple notification process. If no objections are raised, the conversion would be complete. In general, the Pennsylvania proposal is similar to the one proposed in New York, with the exception that a less detailed approach is used, with more discretion given to the trustee to make decisions concerning many of the conventions and rules affecting the administration of the trust, such as the effective date of the conversion, the frequency of distributions during the calendar year, the selection of valuation dates, the treatment for a short year, treatment of personal use property, and other less critical matters.<sup>50</sup> Pennsylvania's proposal puts no time limits on the conversion, and would allow the trustee with court approval to select a payout percentage different from four percent, to provide a distribution of net income (as if the trust were not a unitrust) in excess of the unitrust distribution if such distribution were necessary to preserve a tax benefit, to adopt a smoothing period different from three years, or to reconvert from a unitrust.<sup>51</sup>

Importantly, the Pennsylvania proposal reflects the ordering rule set

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<sup>49</sup> See Pa. S. Bill 1014, §§ 8104(a), 8105(a). The portion of the Bill which contains the Unitrust conversion provisions is set forth in Appendix 1. For full pdf version go to

<http://www2.legis.state.pa.us/WU01/LI/BI/BT/2001/0/SB1014P1261.pdf>.

<sup>50</sup> See Pa. S. Bill 1014, § 8105 (e).

<sup>51</sup> See *id.*, § 8106.

forth in the author's forms that is favorably treated by the Proposed Regulations discussed in Section III below. This means that the four percent payout should carry out with it short term capital gains and then long term capital gains to the extent needed to comprise the full unitrust payout. For this reason, the four percent Pennsylvania payout is more conservative than the New York statute allowing the same rate, and closer to the three percent rate set as a minimum for Missouri, because the New York and Missouri statutes do not contain an ordering rule. Depending upon the cost basis of the trust investments, and the degree of turnover in the portfolio, a four percent unitrust distribution would be equivalent to a 3.3 percent (for a low cost basis portfolio) or to 3.75 percent (for a high cost basis portfolio) distribution in which the capital gains taxes were entirely paid by the trust because capital gains were excluded from DNI.<sup>52</sup> The Pennsylvania Bill also utilizes the UPAIA Section 105, which sets forth the standard of review as abuse of discretion, and generally directs the remedy towards reversal of the prior action by the trustee, such as by suggesting a higher distribution if the distribution was too low or reduction from future distributions if the prior distribution was too high, only referring to surcharge if none of the other remedies are sufficient.<sup>53</sup>

### III. TREASURY'S PROPOSED REGULATIONS— A LATE BUT WELCOME VALENTINE

#### A. Overview of Regulations—Facilitating Helpful Change

The Proposed Regulations arrived on February 15, 2000, as a

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<sup>52</sup> Based upon the author's extensive computer modeling of such scenarios. There are too many variables to succinctly state all of the differences, but the variables include the asset allocation between stocks and bonds, the current accounting income of that asset allocation as compared to the unitrust amount, the turnover in the portfolio, and the cost basis of the investments in the portfolio. To take a simple example, a four percent unitrust payout with a two percent portfolio yield comprised of taxable interest and dividends would after one percent trustee's fees be able to distribute three percent capital gains per year to the beneficiary. At a twenty percent tax rate, this equals sixty basis points (six-tenths of one percent).

<sup>53</sup> See *id.*, § 8106.

welcome one-day-late Valentine for practitioners and state lawmakers awaiting guidance.<sup>54</sup> The Prudent Investor Rule, with its encouragement of total return investment, and the concomitant reconsideration of the concepts of principal and income in the newest version of the UPAIA, raised significant questions. How did these changes in the notion of “income,” namely the power to adjust under Section 104 of the UPAIA and the non-charitable unitrust, fit into the tax mosaic? The concept of trust income is not only vitally important to the trustee and the beneficiaries of a trust, it is interwoven in the tax code at a number of critical junctures, producing the following questions:

1. First, and perhaps most important, a transfer to a trust for a spouse is required to distribute *all of the income* to the spouse during the spouse’s lifetime in order to obtain the benefit of the gift and estate tax marital deduction.<sup>55</sup> Does a unitrust interest or an income interest subject to the power to adjust qualify for that all important deduction?
2. Generally speaking, capital gains realized by a trust do not form a part of distributable net income, which is distributed and taxed to the beneficiary. Clarification was needed as to when such realized capital gains might be included in distributable net income, and therefore, passed out to the beneficiary in the context of the power to adjust and the non-charitable unitrust.<sup>56</sup>
3. How does the addition of the power to adjust or a conversion to a unitrust regime under state law affect the GST grandfathered status of older trusts?<sup>57</sup>
4. How does a state law change to allow the power to adjust or a unitrust definition of income affect net income

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<sup>54</sup> See Prop. Treas. Reg., 66 Fed. Reg. 10396-10402.

<sup>55</sup> See I.R.C. §§ 2523(e), (f); 2056(b)(5), (b)(7).

<sup>56</sup> See Wolf, *supra* note 4, at 153-54; Wolf et al., *supra* note 4, at I-C-47-48; Rosepink, *supra* note 4.

<sup>57</sup> See Wolf et al., *supra* note 4, at I-C-102-03.

charitable remainder trusts and pooled income trusts under Code sections 664(d)(3) and 642(c)(5)?<sup>58</sup>

5. How does a state law change in the definition of income affect the tax treatment of distributions in kind?<sup>59</sup>

The answers to the first three questions in the Proposed Regulations are all favorable to the taxpayer seeking to employ modern investment techniques, whether in the context of a new or existing trust. The Proposed Regulations limit the effect of such changes in state law definition within the context of split interest trusts and require the recognition of gain and loss on the distribution in kind of assets in satisfaction of the obligation to distribute the new “income.”<sup>60</sup>

#### B. The Marital Deduction

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

Such degree of enjoyment . . . that the trust should produce for the surviving spouse during her life *such an income, or that the spouse should have such use of the trust property as is consistent with the value of the trust corpus and with its preservation.*<sup>61</sup>

Ironically, this author and others advocated the use of the unitrust precisely so that the surviving spouse and other income beneficiaries of trusts *could* enjoy a reasonable stream of income that is consistent with the

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<sup>58</sup> See Explanation of Provisions, Prop. Treas. Reg., 66 Fed. Reg. 10397-98.

<sup>59</sup> See *id.* at 10398.

<sup>60</sup> See *id.* at 10399.

<sup>61</sup> See Treas. Reg. § 20.2056(b)(5)(f)(1) (as amended in 1994) (emphasis added). For the most thorough review of the existing income tax treatment of total return trust distributions, and changes brought by the Proposed Regulations, see George L. Cushing, *Income Tax Treatment of “Total Return Trusts,”* ACTEC 2001 ANNUAL MEETING MATERIALS, at B-1-GLC.

value of the trust corpus and its preservation. Without the Proposed Regulations, the only way to ensure that the marital deduction will be allowed is to provide for a payout of the unitrust amount or the income, whichever is greater, at least annually.<sup>62</sup> This payout is generally undesirable because in a high interest rate environment, when the financial markets typically are depressed, the income rule would require the trustee to distribute excess income in a bond-rich portfolio at a time when the trust portfolio is likely to be losing ground to the effects of high inflation.

The power to adjust potentially raised the issue of whether the trustee's authority to make adjustments between principal and income could be a power to appoint trust property to a person other than a surviving spouse, impermissible under Treasury Regulation section 20.2056(b)(7).<sup>63</sup>

Fortunately, the Proposed Regulations change the definition of income under Regulation section 1.643(b)(1):

Trust provisions that depart fundamentally from traditional principles of income and principal, that is, allocating ordinary income to income and capital gains to principal, will generally not be recognized. However, amounts allocated between income and principal pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, including ordinary income, capital gains, and appreciation.<sup>64</sup>

If the Proposed Regulation stopped there, one would be very concerned that Treasury was going to require a year by year allocation of total return. This allocation seems fine in theory, but in practice could be a disaster for the income beneficiary, whose income would be subject completely to the whims of the market. Fortunately, the Proposed Regulations continue as follows:

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<sup>62</sup> See Wolf, *supra* note 4, at 83-84; Wolf et al., *supra* note 4, at I-C-42.

<sup>63</sup> See Cushing, *supra* note 61, at B-15-GLC.

<sup>64</sup> Prop. Treas. Reg., § 1.643(b)(1), 66 Fed. Reg. at 10401.

For example, a state law that provides for the income beneficiary to receive each year a unitrust amount of between three percent and five percent of the annual fair market value of the trust assets is a reasonable apportionment of the total return of the trust. Similarly, a state law that permits the trustee to make equitable adjustments between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries is generally a reasonable apportionment of the total return of the trust. These adjustments are permitted when the trustee invests and manages the trust assets under the state's prudent investor standard; the trust describes the amount that shall or must be distributed to a beneficiary by referring to the trust's income; and the trustee after applying the state statutory rules regarding allocation of income and principal is unable to administer the trust impartially.<sup>65</sup>

Both the unitrust and the power to adjust qualify for the marital deduction under the Proposed Regulations, *provided that the state law provides the requisite support*.<sup>66</sup> However, questions remain. The language describing the power to adjust sets out all of the requirements contained in the UPAIA, including the application of a prudent investor standard. In theory, this could mean that a state without the prudent investor standard, or whose version of the UPAIA does not refer to that standard, might not receive the Treasury's blessing for the application of the power to adjust. This nuance is descriptive and should not be a necessary limitation. Granting an adjustment power to a trustee that, for one reason or another, is not subject to the prudent investor standard of the state may be logical. One example is a trust that by its terms has opted out of that standard, but in which the trustee still has the goal of treating the beneficiaries impartially and investing for total return. Nevertheless, at this juncture, that result is not entirely clear.

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<sup>65</sup> *See id.*

<sup>66</sup> *See id.*

### C. Capital Gains as a Part of Distributable Net Income

Generally speaking, capital gains incurred in a trust do not form a part of distributable net income and, therefore, are taxed to the trust rather than to the income beneficiary.<sup>67</sup> Current Regulations provide the following three exceptions:

- (a) Capital gains are allocated to income by the governing instrument or local law;
- (b) Capital gains are allocated to corpus and actually distributed to the trust beneficiaries during the year; or,
- (c) Capital gains are utilized in determining the amount which is required to be distributed pursuant to the governing instrument or the practice followed by the fiduciary.<sup>68</sup>

Within the context of the total return unitrust or the power to adjust, these requirements raised questions. As this author and others had urged, an ordering provision that functioned largely like the Regulations for the charitable remainder unitrust was sensible for the non-charitable unitrust; that is, the accounting income would be distributed first, then the short term capital gains, then the long term capital gains, and finally the principal of the trust.<sup>69</sup> If this were not the case, one would have the anomalous situation in which the income beneficiary of a trust invested largely in equities might be getting a generous payout of three percent to five percent of the value of the trust, but because of the low accounting income and the deductibility of trustee's fees, the beneficiary might pay little or no income tax on the unitrust distribution, while the trust itself paid any capital gains taxes as a result of the total return approach. In substance, as long as the approach to allocation of the capital gains to the trust or the beneficiary was consistent, no important tax policy would be offended by giving the drafter or the trustee the choice of allocation. The Treasury accepted this philosophy by adding the following language to the definition of income in

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<sup>67</sup> See Cushing, *supra* note 61, at B-5-GLC.

<sup>68</sup> See Treas. Reg. § 1.643(a)-3(a) (1994).

<sup>69</sup> See Wolf et al., *supra* note 4, at I-C-40, I-C-47.

the Proposed Regulations:

In addition, an allocation of capital gains to income will be respected if the allocation is made either pursuant to the terms of the governing instrument and local law, or pursuant to a reasonable and consistent exercise of a discretionary power granted to the fiduciary by local law or by the governing instrument, if not inconsistent with local law.<sup>70</sup>

The Proposed Regulations added a number of examples that make clear that an ordering rule within the state statute will be respected. Example 9 describes a unitrust statute with a four percent payout when state law provides that the unitrust amount shall be considered paid first from ordinary income, then from net short-term capital gain, then from net long-term capital gain, and finally from return of principal.<sup>71</sup> The ordering rule is approved specifically by Example 9.

Examples 10 and 11 are premised upon the fact that neither state law nor the governing instrument has an ordering provision rule for the character of the unitrust amount, but leaves such a decision up to the trustee. Collectively they provide that the trustee can adopt either of the following approaches for the reporting of capital gains: either including it in DNI or excluding it from DNI, provided that the exercise of discretion is consistent on a year-to-year basis.<sup>72</sup>

These examples provide helpful discretion to trustees. However, one remaining question is whether, in the absence of an ordering provision in state law or the governing instrument, a fiduciary that has allocated capital gains to corpus and paid the tax at the trust level because it did not think that any other treatment was permissible will be able to change its method once the Proposed Regulations are put in final form. The author submits that this should be permitted, since for most trusts this would not have been permissible prior to the changes brought about by the Proposed

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<sup>70</sup> See Prop. Treas. Reg., § 1.643(b)-1, 66 Fed. Reg. at 10401.

<sup>71</sup> See *id.*, § 1.643(e), example 9, at 10400.

<sup>72</sup> See *id.*, examples 10 and 11.

Regulations. Existing trusts should be able to receive the benefit of this helpful flexibility now that it is clearly available to newly created trusts.

Several additional points should be considered for the final version of these Regulations in the author's opinion. First, a three year smoothing rule should be inserted into Example 9 so that the nearly universal use of a smoothing rule would be expressly condoned. The three year rule should be used because all of the state statutes that utilize a private unitrust as a definition of income either allow or require the use of a smoothing rule in order to make the beneficiary's distribution less volatile.<sup>73</sup> The omission of this detail from the Proposed Regulations was likely inadvertent.

The ordering rule in the Proposed Regulations speaks of "ordinary income" rather than "accounting income." This terminology leaves tax-free income out of the picture because it is neither ordinary income nor a "return of principal." "Traditional accounting income" could be inserted in the place of "ordinary income." This would allow the income beneficiary to receive proportionate benefits from the tax-free income after reduction of deductible expenses.

On a finer note, the Explanation of Provisions section relates that capital gains are to be included in distributable net income to the extent that they are treated so pursuant to the governing instrument *or* local law.<sup>74</sup> In the definition of income in the Proposed Regulation, however, the word "and," not "or," is used.<sup>75</sup> This is different from the standard set forth for the exercise of the discretionary authority in the trustee which must be made either "pursuant to a reasonable and consistent exercise of a discretionary power granted to the fiduciary by local law or by the governing instrument, if not inconsistent with local law."<sup>76</sup> The final version should state whether the state law requirement, when the governing instrument provides the ordering rule, is really an "and," an "or," or a "not inconsistent with state law."<sup>77</sup>

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<sup>73</sup> See *supra* text accompanying notes 24-53.

<sup>74</sup> See Prop. Treas. Reg., 66 Fed. Reg. at 10398.

<sup>75</sup> See *id.* at 10397.

<sup>76</sup> See *id.* § 1.643(a)-3(b), at 10400.

<sup>77</sup> The last stated is the author's choice for consistency.

The Proposed Regulations' effect on other types of total return trusts, such as indexed annuity trusts, TRUCAP indexed trusts (trusts that pay out an indexed annuity not to exceed a unitrust "cap"), and other trusts discussed later in this article, is not clear. As a general proposition, Treasury should allow an ordering rule or a consistently applied exercise of discretion pursuant to the governing document or applicable state law even if the payout regime is different from the power to adjust or the unitrust.<sup>78</sup> The Treasury could provide a beneficial addition to the Proposed Regulations by addressing the issue of capital gains ordering and trustees' discretion in a slightly broader sense.

#### D. What about Grandfathered Trusts?

Final Regulations were issued in December, 2000 that expressly approved a conversion of a GST grandfathered income only trust to a unitrust when the modification provided for the payment of income in excess of the unitrust interest if the income were greater than the unitrust amount.<sup>79</sup> This left open the question of whether a previously grandfathered income only trust paying out a current yield of perhaps two percent would be exposed to the GST tax if converted to a four percent unitrust.<sup>80</sup> Fortunately, the Proposed Regulations answer this question as to the unitrust and the power to adjust:

In addition, administration of a trust in conformance with applicable state law that defines the term income as a unitrust amount, or permits the trustee to adjust between principal and income to fulfill the trustee's duty of impartiality between income and principal beneficiaries, will not be considered to shift a beneficial interest in the trust, if the state statute provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and meets the

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<sup>78</sup> See Cushing, *supra* note 61, at B-18-GLC-B-19-GLC.

<sup>79</sup> See Treas. Reg. § 26.2601-1(b)(2).

<sup>80</sup> See Wolf et al., *supra* note 4, at I-C-90.

requirements of Section 1.643(b)-1 of this chapter.<sup>81</sup>

Conversion to a unitrust payout that comports with the general definition of income under Regulation section 1.643(b)-1 will not create any difficulty for GST purposes, nor will the adoption of the power to adjust under UPAIA cause a problem for GST grandfathered trusts. For trusts in a state without an express statutory power to convert to a unitrust, however, the GST tax concern will remain. Even if a unitrust conversion were accomplished under some other statute, or under applicable case law, the change would have to use a “unitrust or income, whichever is the greater” approach to fall within the original final GST regulations because it would not gain relief from these Proposed Regulations.

E. How Do the Proposed Regulations Deal with Charitable Split Interest Trusts?

The Proposed Regulations deal somewhat less kindly with changing the definitions of income under state law in the context of Pooled Income Trusts and Charitable Remainder Unitrusts. For Pooled Income Trusts, where long term capital gains receive the benefit of the charitable deduction, the power to adjust at the discretion of the trustee and a unitrust definition of income are expressly disallowed.<sup>82</sup> For the Pooled Income Trust, where the theory of the charitable deduction for capital gains is that all capital gains will eventually go to the charity, the change to a unitrust definition introduces the probability that a portion of the capital gains will go to the non-charitable beneficiary, clearly justifying the position of the Proposed Regulations.

The proposed revision of the charitable remainder unitrust regulations raises more interesting questions.<sup>83</sup> On the surface, the change seems sensible enough. The Net Income Unitrust provides that the distribution to the non-charitable beneficiary shall be the lesser of the income earned in the trust or the stated unitrust amount, which must be at

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<sup>81</sup> Prop. Treas. Reg. § 26.2601-1(b)(4)(i)(D)(2), 66 Fed. Reg. at 10402.

<sup>82</sup> See Prop. Treas. Reg., § 1.642(c)-2, 66 Fed. Reg. at 10399.

<sup>83</sup> See *id.*, § 1.664-3, at 10401.

least five percent.<sup>84</sup> If a unitrust income definition of perhaps four percent were adopted, what would be the result? Functionally one would have a unitrust within a unitrust, not very sensible or useful from the point of view of the non-charitable beneficiary, who is generally seeking some flexibility to defer income until it is needed later, at retirement for example. But what tax policy is being protected here? One might suppose that once a NICRUT were in effect, the change from an ordinary definition of income to a unitrust definition of income would probably raise the income to the non-charitable beneficiary. However, no benefit from this deduction is enjoyed on the front end because the valuation method is the same for the charitable interest, whether a straight unitrust or a NICRUT is used.

This raises a more interesting and important point about unitrusts generally, which are required to pay out at least five percent per year. Because of the recently added ten percent requirement for the charitable interest,<sup>85</sup> the five percent minimum precludes the use of a CRUT for a very young person. At the November 7520 rate of five percent, a CRUT could not be started for a twenty-three year old, simply because her interest at a five percent payout exceeds ninety percent using the applicable treasury tables.<sup>86</sup> Why as a matter of policy should the payout not be allowed down to some sensible limit, such as three percent? This would take away the arbitrary age limitation from the combination of the current requirements, and allow planners to use more conservative rates of payout for CRUTs generally. Why not allow a three percent CRUT to be drafted for a fifty or sixty year old? For the donor, it would increase the available deduction, but no subterfuge exists here. The charity will get much more benefit with a lower rate unitrust payout. The logic that likely precipitated the five percent minimum used in section 664 came from the minimum investment return rules of section 4942, which were to ensure that charitable interests really participated in the trust's charitable purposes. However, such logic does not apply when it limits the charities' interests, not the taxpayers' interests. Indeed, while Treasury is looking in a broad

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<sup>84</sup> See I.R.C. § 664(d)(2).

<sup>85</sup> *Id.* at § 664(d)(2)(D).

<sup>86</sup> According to Leimberg & LeClair's Numbercruncher (a software program), a twenty-three year old's interest in a five percent CRUT payable quarterly at five percent, using the November 7520 rate of five percent, represents 90.384 % of the value, too high to pass the ten percent test.

sense at the income and principal rules, revisiting section 4942 would make sense as well. The five percent minimum investment return requirement for private foundations can only cause trouble for the trustee and the beneficiaries of such trusts, particularly in states that have not allowed a change in their income rules to allow a total return unitrust approach for such trusts. Without that relief, the trustees are forced to produce enough accounting income to satisfy the payout requirement, substantially impairing the prudence of their trust investment portfolio.

F. How Do the Proposed Regulations Deal with Distributions in Kind?

The answer to this question is clear enough under the Proposed Regulations. The satisfaction of a unitrust payout defined as “income” under section 643(b) will result in recognition of gain, even if the distribution is done on a fractional basis, because the payment would be in satisfaction of the obligation of the trust to pay income as newly defined.<sup>87</sup>

G. What Do These Regulations Mean for Drafters and States Considering Changes in Their Definitions of Income?

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

The issuance of the Proposed Regulations shifts the legislative dynamic. Before these regulations, the question was why a state would

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<sup>87</sup> See Prop. Treas. Reg., § 1.651(a)-2(d), 66 Fed. Reg. at 10401. Presumably if the trust situs were not in a state in which the unitrust amount would qualify as income under the Proposed Regulations, distribution in kind of an appreciated security as part of a fractional distribution requirement would continue to be a non-recognition event.

want to be first to make these important changes. Now the question is whether any state can afford to be the last to do so. States that make these changes in their state law will benefit the trustees and beneficiaries of trusts within their borders because of the freedom that the new provisions provide, and will provide a more favorable tax climate for their trusts. The treatment of income under the Code was and continues to be a concept tied to state law. Those states that are quick to adopt statutory changes to allow both the unitrust and the power to adjust will offer the following advantages.

- (a) A unitrust distribution will qualify for the marital deduction without also requiring a distribution of the “income or unitrust amount, whichever is the greater.” This eliminates the possibility of future conflicts of interest in high interest rate environments.
- (b) A conversion to a unitrust will not create risk from a GST perspective, even without introducing the “income or unitrust amount, whichever is greater.” Example 11 in the Proposed Regulations seems also to lessen any concerns that such a conversion, when pursuant to a state law change, might generate transfer tax questions by including a fact pattern in which the beneficiaries must consent to the conversion.<sup>88</sup>
- (c) A state with a statutory ordering rule for unitrust distributions will create a clear path for trustees to include short and long term capital gains as part of DNI. This allows a prudent payout to be higher than would be possible if the gains were taxed to the trust. Those states desiring to grant discretion to the trustee to include or not include capital gains as part of DNI might do well to include such discretion specifically in their statutory language because, otherwise, such discretion might well be uncertain under most governing documents and applicable state law.

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<sup>88</sup> *See id.* at 10400.

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

States that promptly consider and act upon these beneficial state law changes will be at a significant competitive advantage in the attraction and retention of trust business, when contrasted with states that have not made these changes.

Having reviewed recent developments in state law and Treasury's Proposed Regulations, which clear the way for total return trusts, this Article will now turn to a more in-depth examination of estate planning with total return trusts.

#### **IV. ESTATE PLANNING WITH TOTAL RETURN TRUSTS**

- A. Take TRU Aim: The TRU Allows the Economic Benefits to Be Divided in Accordance with Grantor's Intent

Strangely, at least if one views the matter from a perspective other than that of a trusts and estates professional, our traditional trust forms typically do not prescribe how much is to be distributed to the current beneficiary or the remainder beneficiary. They typically simply state that the trustee is to hold the principal and pay the income. What the income may be will depend on the investment environment at the time the trust goes into effect and the manner in which the trust is invested. And our trust documents typically do not prescribe how the trust is to be invested. In fact, a number of pages in the typical trust are spent making as clear as possible that the trustee should be able to do whatever the trustee thinks is the best thing. Now all of this might be confused with flexibility, if not for the fact that most trust documents do not describe the goal of the trust.

Consequently, in theory at least, the trustee is left adrift at sea, and the economic value that flows to the current beneficiary and the remaindermen is likely to be dependent upon which direction is chosen. If the trust is invested primarily in bonds, the majority of the economic benefit

will flow to the current beneficiary, while if the trust is invested primarily in equities, the majority of the benefit may be divided more evenly depending on the period of time during which the current beneficiary retains an interest.

Other more innovative styles of trusts, such as an indexed payout trust, will prescribe the amount that the current beneficiary is to receive, but the proportion of the entire economic benefit flowing to the current beneficiary will vary widely depending in part on how the trust is invested and in part on the future return from those investments. Because the current beneficiary's return is determined by the instrument and a factor that is not directly related to the return from the trust, inflation, the portion of the economic value passing to the current beneficiary and the remaindermen will depend entirely on future returns and future inflation, which cannot be predicted by the grantor or testator. This will significantly increase the possibility that the economic value will not be shared in the manner contemplated.

In Jonathan R. Macey's extraordinary work, *An Introduction to Modern Financial Theory*,<sup>89</sup> prepared for the American College of Trust and Estate Counsel Foundation, Professor Macey points to the revisions in the law that would allow the trustee to try to allocate returns in accordance with the settlor's probable intent:

In forthcoming revisions to the law, trustees should not be compelled to allocate trust earnings simply on the basis of the form that an investment's payout happens to take. Rather, trustees should be permitted to allocate a trust's capital appreciation to income beneficiaries and dividend income to remaindermen where doing so is consistent with the settlor's probable intent. For example, suppose that a settlor creates a trust in 1990 with a corpus of \$100,000. A trustee who invests in a diversified portfolio of high yield

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<sup>89</sup> JONATHAN R. MACEY, AN INTRODUCTION TO MODERN FINANCIAL THEORY (2d ed. 1998). What is extraordinary about it is not what he says, but that he says it as simply and readably as he does. This book is an excellent primer for lawyers or other trust professionals seeking to peek into the window of financial theory.

junk bonds may provide the income beneficiary with a handsome return, but inflation may erode the value of the remainder interest. Trustees should be able to right this imbalance by reallocating some of the interest income to the remaindermen. Similarly, a trustee who invests in a high tech firm that pays no dividends yet enjoys a spectacular increase in market value should be permitted to allocate some of the capital gains to the income beneficiary.<sup>90</sup>

The foregoing clearly points to the concept behind Section 104 of the UPAIA. Professor Macey then discusses Professor John Langbein's suggestion that we should encourage the settlor to express his or her intent with a simple checklist of alternatives which might include the following:

- (a) All accretions of value beyond the nominal principal would go to the income beneficiary and the nominal principal would be preserved for the remaindermen.
- (b) The trustee would be required to retain sufficient trust earnings to preserve the constant dollar purchasing power of the trust corpus for the remaindermen, or
- (c) The trustee could "be instructed to add to the corpus of the trust on a fixed percentage basis, and to pay the rest out to the remaindermen."<sup>91</sup>

The thought that the testator or settlor should consider and prescribe how much of the economic benefit might go to the current beneficiary and the remaindermen is a valuable insight. Would the use of a fixed percentage unitrust with a smoothing rule allow the settlor or testator to prescribe just how much of the economic benefit would pass to the current beneficiary and the remaindermen? As we will see, the TRU builds very well upon this insight.

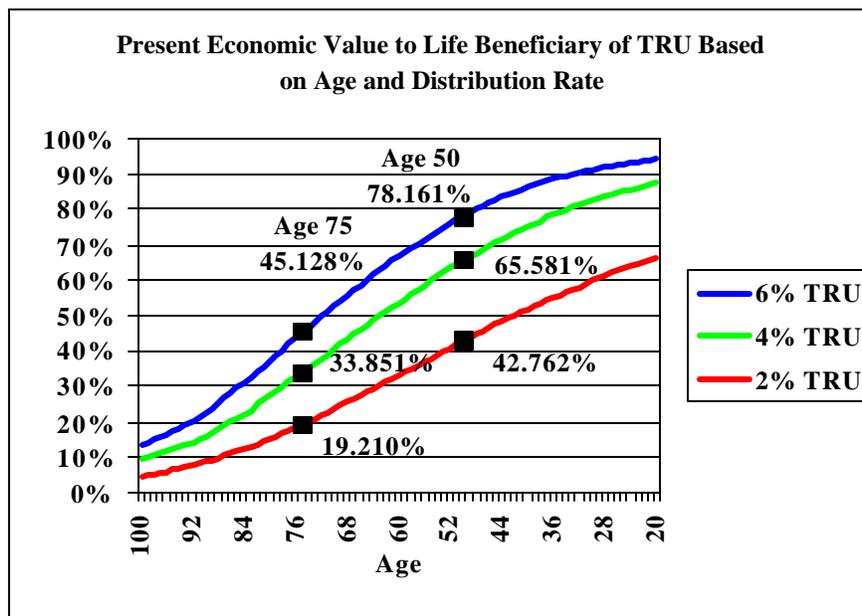
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<sup>90</sup> See *id.* at 78-79.

<sup>91</sup> *Id.* at 79-80.

A unique characteristic of a unitrust is that the portion of the economic value that passes to the life beneficiary and the remaindermen will vary only with the payout rate and the duration of the interest. It will not depend in any way upon the future investments' returns for two reasons. First, the current beneficiary and remainder interests share the same fate. If the value of the trust increases, so does the current beneficiary's distribution, and if the value decreases, so does the current beneficiary's distribution. Second, to evaluate the present value of a future stream of payments, one must discount it by a rate appropriate given the risk and return characteristics in the market. If one assumes a discount rate is equal to the actual future return on the funds, the proportion of economic benefit passing to the current and remainder beneficiary will remain the same agnostic to the future rate of return. The following page reveals a graph of the economic value to a life beneficiary of a TRU based on current age and distribution rate. The economic value of a two percent, four percent, and six percent TRU passing to the life beneficiary are graphed here, highlighting specific ages: age fifty, perhaps the average age at which a child inherits from a parent; and, age seventy-five, perhaps the average age of a surviving spouse.

Although the change in the present values of the current interests is not a linear function, the portion of the economic interest passing to the current beneficiary will be largely proportional to the payout rate at a given age of the beneficiary. The real value will, of course, be based upon some unknowns such as actual life span. We simply are using the life expectancy of a current beneficiary. But by using a TRU, we are allowing the settlor or testator a much greater hand in focusing how much of the benefit goes to the current beneficiary and the remaindermen. This seems to be a logical extension of Professor Langbein's point of view, tempered by the results of computer modeling of the different theoretical divisions of economic value. No other distribution rule will effect this result, only the TRU, because the current interest changes with the value of the trust estate.



B. TRU Design Boosts Tax Planning Leverage to a Whole New Level Painlessly!

This ability to focus economic benefit to whom we wish has some very powerful applications in the estate planning field. To see how this might work, we can use a case study. Successful Sylvester and Supportive Sally are both about fifty years of age when they come to the planner with the following assets:

	Successful <u>Sylvester</u>	<u>Joint</u>	Supportive <u>Sally</u>
Cash and securities	\$2,000,000		\$450,000
Residence		\$350,000	
Life insurance	<u>250,000</u>	<u>                    </u>	<u>50,000</u>
	\$2,250,000	\$350,000	\$500,000
Total assets	\$3,100,000		

Now let us assume that in the event of Sylvester's death, Sally needs a total of \$90,000 per year in income from the trusts under his will.

Note that in the traditional trust estate plan the question of the surviving spouse's future income *needs* might not be discussed at all, and if they are, the estate planner would be able to say only that the income, and if necessary the principal, would be available to Sally. Indeed, such a discussion would be an unhappy one if it occurred at all, because in order to generate the \$90,000 Sally needs, the trusts would have to be invested in seventy-seven percent fixed income and only twenty-three percent equities. That, of course, would startle any professional trustee into opposition and, if implemented, would probably doom Sally to a substandard lifestyle in her later years.

If such a mix were adopted, inflation would eat away at Sally's income for the rest of her life, gradually eroding the purchasing power of the income. Such a small proportion of equities never would be able to make up for the four-fifths of the trust portfolio that cannot grow at all. Because she would be such a young widow, this would be truly disastrous.

With a TRU, we can plan things differently. Suppose we divide the estate as we normally would into a marital and residuary trust with a marital trust of \$1,550,000 and the residuary credit shelter trust of \$650,000, the applicable credit amount in 1999. Suppose further that we would satisfy Sally's income needs by paying out five percent from the marital trust and two percent from the residuary credit shelter trust. Of course, we might also have to pay the income if it were greater than the five percent in the marital trust to ensure receipt of her marital deduction, unless she lived in a state with a unitrust statute. The combined distributions would give us slightly more than the \$90,000 needed by Sally. Because our trusts are not tied to a payout based on income, we could invest the residuary credit shelter trust entirely in equities, and to be conservative, the trustee could invest half of the marital trust in bonds and half in stocks.

If this were done, the performance was like the period 1960 to 1998, and Sally lived to age eighty-eight, our marital trust would have grown to \$5,769,621 and our residuary credit shelter trust, paying out two percent, would have grown to \$13,481,068. Had the trustee felt safe enough to invest the funds in order to produce income of \$90,000 in an income rule

trust, we would have ended up with a combined marital and credit shelter trust of only \$3,700,000.<sup>92</sup>

These good results would be even more favorable to Sally's children because the majority of the growth in value occurred in the residuary credit shelter trust, as it would not be taxed at Sally's death. The estate planner could increase the economic benefit even more by raising the marital payout percentage from 5% to 5.8% and making the residuary credit shelter trust fully discretionary, so that none of the credit shelter trust would have to be paid out during Sally's lifetime. This would allow the residuary credit shelter trust to build to over \$20,000,000 with the marital trust growing to \$4,400,000.

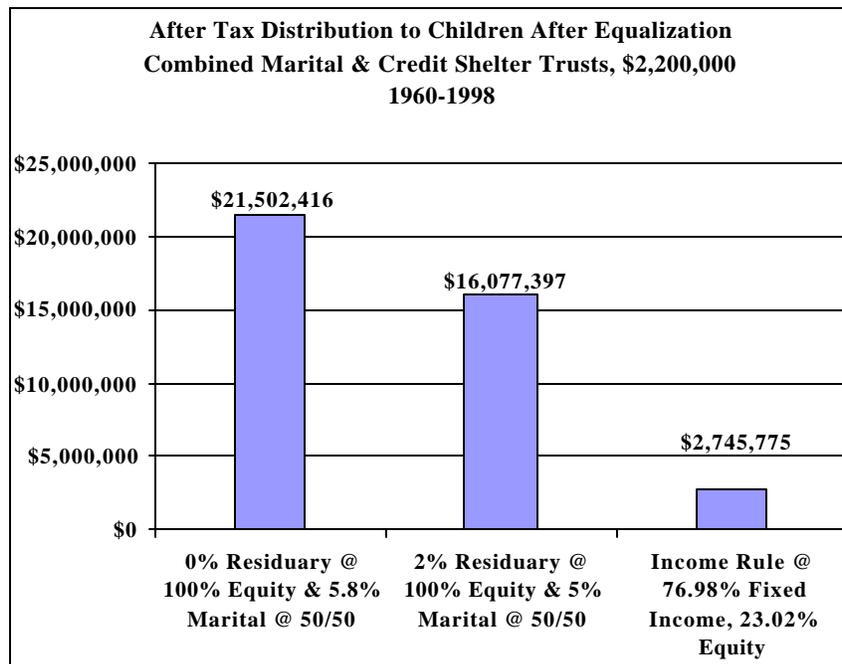
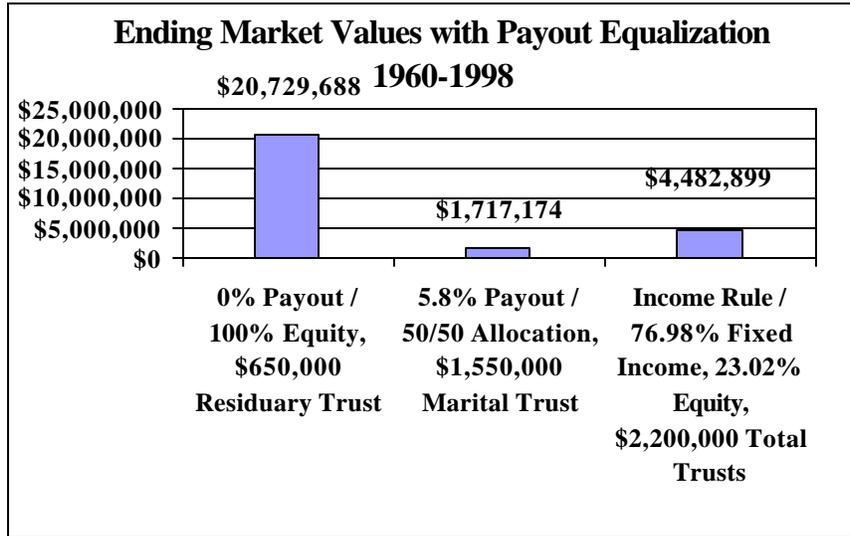
To level the playing field truly, however, we would have to pay additional funds from the marital trust in addition to the distribution amount. While the 5.8% payout marital trust would have started out at the same level of distributions as the prior example of a five percent marital trust and a two percent credit shelter, the distributions would have grown more slowly than the combination of lower payouts because of the conservative asset allocation and the higher payout. When the after-tax payouts have been equalized, the bar chart below would represent the trust alternatives.

The trustee would have had to pay significant additional funds from the marital trust, which would have whittled down the taxable estate of Sally as surviving spouse to only \$1,700,000, while leaving the over \$20,000,000 in the residuary credit shelter trust intact. In contrast, the income rule trust, with payout equalization, would have almost \$4,500,000.

Here are three approaches, side by side, after taxes in Sally's estate. See second bar chart that follows.

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<sup>92</sup> See Wolf, *supra* note 4, at 150-53 (describing the methodology and assumptions underlying the author's computer modeling).



The foregoing represent the three approaches discussed above. The first bar represents the net result of using a discretionary residuary credit shelter trust paying nothing, and a 5.8% marital total return unitrust distributing additional principal to match the after-tax cash flows of the five percent and two percent TRUs. The second bar represents the five percent marital and two percent residuary credit shelter trust. The third bar represents the income rule trust invested as was necessary to satisfy Sally's initial need for income with income reinvested when possible and principal used when necessary to equal after-tax cash flows. Using the two types of total return trusts together, the discretionary trust and the total return unitrust, is the most beneficial alternative. In after-tax returns, the remaindermen receive eight times the net available from the ordinary income rule trusts without sacrificing one dollar of net after-tax income to Sally. This is the logical extension of focusing economic benefit.

One might ask: was the 1960 through 1998 period representative of long-term financial markets? For an all-equity portfolio, one probably would think that this period was unduly favorable, and to an extent that is true. The 1926-1999 large stock total return is 11.3%, while the return illustrated above is 12.25%. If one computer modeled all of the thirty-nine year periods since 1926 with an income rule trust that has seventy-seven percent fixed income and twenty-three percent equities, the average ending value would have been seven and one-half percent higher during 1960 through 1998 than it was on average throughout the entire seventy-four years of recent investment history. Interestingly, however, if one were looking over this analysis on an inflation adjusted basis, one would find that the investment results from 1960 through 1998 were sub par simply because of the average inflation rate of 4.58% from 1960 to 1998, fully 1.5% above the average from 1926 through 1998.

The planner should focus as close to 100 percent as possible of all of the economic benefit passing to the credit shelter trust at the remaindermen, while focusing as much as necessary from the marital trust to the surviving spouse. This optimizes the ability to invest for total return, to satisfy the human needs involved, and to leverage the tax benefits all at the same time. This flows from being able to focus economic benefit.

Particularly after the passage of EGTRRA, a new type of unitrust called “an ordered unitrust” is even more desirable than the marital TRU and fully discretionary credit shelter trust illustrated above, because the ordered unitrust can reduce the substantial variation over time in the size of the credit shelter trust. In an ordered unitrust, the overall distribution rate is held constant as a function of the market value of both the marital and the credit shelter trusts, but the entire TRU payout is directed from the marital TRU. An example of such an ordered TRU is Form 6 in Appendix 2.

C. What is the Right Rate?

What rate is optimal for the life tenant in a long-term TRU? As noted above, the “right” rate depends most critically upon whom the settlor wishes to receive the majority of the economic benefit. Trying to focus our benefits to maximize the benefit of the applicable credit amount and the GST exemption might be tremendously important.

But what if the primary goal is to support the life beneficiary and not to maximize the amount remaining in the trust for the remaindermen? The answer to that question, important as it is, requires consideration of another question: how much does the beneficiary truly need given the facts known to the drafter at the time the plan is created? In deciding what the beneficiary may need, the settlor and the drafter should consider that the lower the rate, the more secure the trust will be, and the more the income stream will grow. An explanation of the table below, showing the unitrust payouts from a three percent, four percent, five percent, and six percent TRU portfolio invested 100 percent in equities during the period 1960 through 1998, follows.

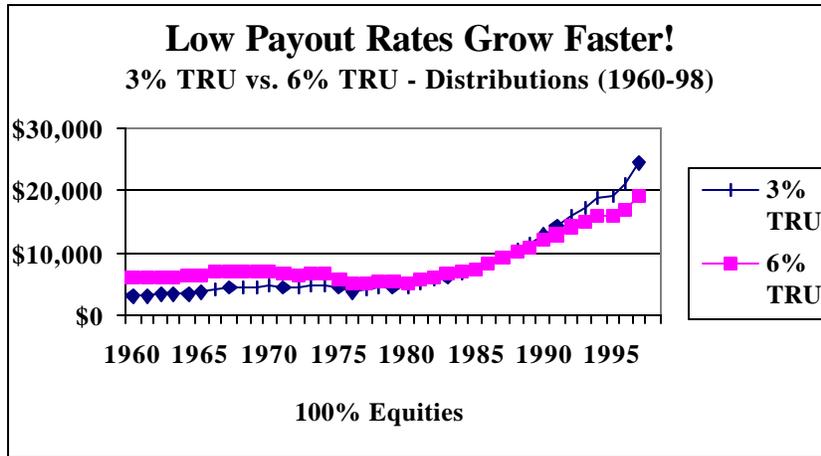
**TABLE**  
**COMPARISON OF RESULTS FOR UNITRUST PAYOUTS OF 3%, 4%,**  
**5%,**  
**AND 6 % FOR THE PERIOD 1960-1997 AFTER TAXES AND EXPENSES**  
**100% EQUITY PORTFOLIO IN THE LONG-RUN,**

**THE LOWER THE PAYOUT RATE THE BETTER**

Year	3% Payout	Market Value	4% Payout	Market Value	5% Payout	Market Value	6% Payout	Market Value
Dec 1960	3,000	96,238	4,000	95,233	5,000	94,228	6,000	93,223
Dec 1961	2,944	117,879	3,905	115,651	4,856	113,433	5,797	111,226
Dec 1962	3,141	103,039	4,145	100,077	5,128	97,091	6,089	94,135
Dec 1963	3,172	121,958	4,146	117,380	5,079	112,815	5,972	108,328
Dec 1964	3,429	136,925	4,441	130,823	5,389	124,610	6,274	118,549
Dec 1965	3,619	148,299	4,644	140,707	5,575	132,996	6,420	125,406
Dec 1966	4,072	127,472	5,185	119,783	6,174	112,098	7,046	104,514
Dec 1967	4,127	152,064	5,218	141,710	6,162	131,333	6,969	121,217
Dec 1968	4,278	162,184	5,363	149,981	6,274	137,895	7,023	126,035
Dec 1969	4,417	141,995	5,486	130,089	6,355	118,467	7,035	107,099
Dec 1970	4,562	140,746	5,624	127,731	6,462	114,973	7,087	102,688
Dec 1971	4,449	154,458	5,437	138,969	6,189	123,787	6,716	109,366
Dec 1972	4,372	176,953	5,291	158,107	5,954	139,680	6,383	122,279
Dec 1973	4,722	144,185	5,664	127,542	6,307	111,514	6,687	96,554
Dec 1974	4,756	100,275	5,662	87,350	6,250	75,067	6,564	63,838
Dec 1975	4,214	132,013	4,973	113,690	5,438	96,533	5,653	81,059
Dec 1976	3,765	157,729	4,381	134,852	4,719	113,498	4,829	94,434
Dec 1977	3,900	140,142	4,479	118,960	4,752	99,279	4,787	81,863
Dec 1978	4,299	142,475	4,900	120,154	5,155	99,404	5,147	81,079
Dec 1979	4,403	161,121	4,986	135,165	5,203	111,021	5,148	89,679
Dec 1980	4,437	203,976	4,990	170,477	5,162	139,354	5,052	111,873
Dec 1981	5,076	184,910	5,677	153,563	5,830	124,723	5,653	99,279
Dec 1982	5,500	212,727	6,123	175,772	6,252	141,922	6,017	112,113
Dec 1983	6,016	249,385	6,664	205,084	6,767	164,598	6,465	129,081
Dec 1984	6,470	252,733	7,126	206,713	7,187	164,685	6,809	128,120
Dec 1985	7,148	319,388	7,834	260,153	7,853	205,920	7,386	159,119
Dec 1986	8,215	362,685	8,959	294,032	8,920	231,244	8,326	177,409
Dec 1987	9,348	367,204	10,145	295,469	10,031	230,500	9,293	175,385
Dec 1988	10,493	410,753	11,329	327,918	11,128	253,742	10,238	191,486
Dec 1989	11,406	518,536	12,232	411,450	11,925	316,182	10,886	236,943
Dec 1990	12,965	479,628	13,798	377,319	13,340	287,387	12,076	213,430
Dec 1991	14,089	600,407	14,889	468,882	14,289	354,487	12,837	261,292
Dec 1992	15,986	618,145	16,769	478,707	15,968	358,858	14,233	262,241
Dec 1993	16,982	650,764	17,665	499,771	16,679	371,494	14,739	269,150
Dec 1994	18,693	628,920	19,298	478,376	18,081	352,135	15,854	252,593
Dec 1995	18,978	830,531	19,425	627,303	18,041	458,490	15,680	326,515
Dec 1996	21,102	982,501	21,406	737,026	19,702	534,970	16,965	378,311
Dec 1997	24,420	1,262,553	24,569	941,289	22,427	678,999	19,148	477,149

Dec 1998	30,756	1,562,471	30,742	1,157,46	27,874	829,563	23,640	579,147
			9					
Negative 5 Changes		6		10			11	
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One notes a number of things in comparing these payouts. First the payouts clearly converge over time. The lower payouts grow faster than the higher payouts and eventually catch up if the period is long enough. By the end of this thirty-eight-year period, the three percent payout has surpassed the five percent and six percent payouts by the sheer force of compounding. At the same time, the distribution is smoother with only half as many negative changes in a three percent payout as in five percent payout. The graph comparing the three percent unitrust and the six percent unitrust distributions further illustrates the concept.



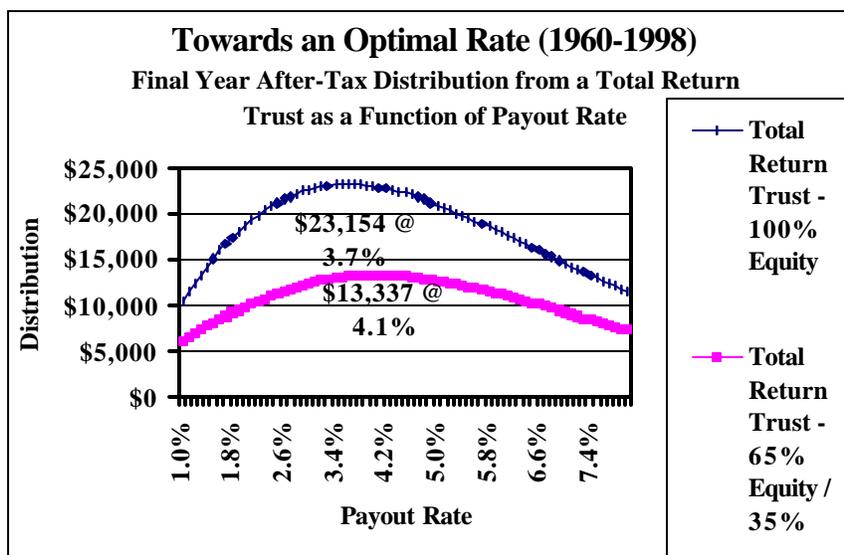
Measuring the decline during the 1970s in these two trusts reveals the three percent TRU experiences a 20.8% decline between 1973 and 1976, and the six percent payout declines twenty-eight percent during the same period and thirty-two percent before the decline is reversed.

Lower payouts are safer and better for everyone if the current beneficiary's needs still can be sensibly met.

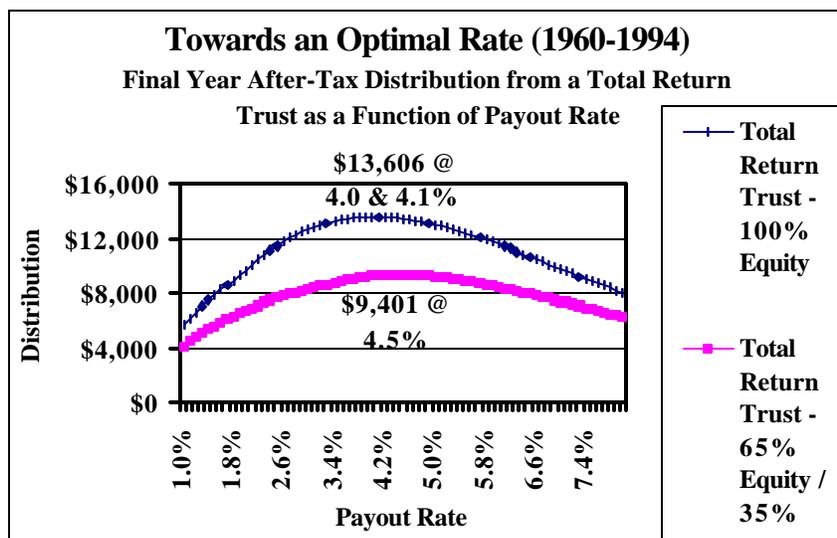
But if we were to disregard the interests of the remaindermen, what would be the ideal rate from the current beneficiary's point of view taking into account the effects over a long period of time?

One approach to this question would be to consider the after-tax income to the life beneficiary at the end of a long period (perhaps comparable to a middle-aged beneficiary's life expectancy) and determine what rates would produce the highest after-tax income at the end. If the rate is "too high," then by the last year a lower rate surely would have caught up and surpassed it. If the rate chosen over a long period of time produces the highest possible after-tax income at the end of the period, then it was not too high for the current beneficiary. Of course, it may not have been high enough, but that is best addressed as part of the first question: what is the need?

The following is a graph of after-tax distributions in the year 1998 from the period 1960 through 1998 with two alternative portfolios, the first, 100 percent equity portfolio and, the second, a 65% equity/35% bond portfolio.



One notices several trends demonstrated in this graph. The first is that the 100 percent equity is paying out much more money at the end of the period than the sixty-five/thirty-five portfolio. This should come as no shock. The second point is that with both of the portfolios, the rate that produces the highest after-tax income at the end of this long thirty-eight-year period is near four percent. However, we know that the last four-year period has been extraordinary, even unprecedented; therefore, we created the same graph for 1960 through 1994.



Perhaps not intuitively, the rate that produces the highest income at the end of the period is actually higher ending in 1994 suggesting a four percent rate for all equity and a 4.5% rate for a sixty-five percent equity, thirty-five percent bond portfolio. The “optimal” rate is higher under these circumstances for two reasons. First, the longer the period, the better a low rate does, and the higher the return during the period the faster a lower payout will catch up. That is the reason this four-year period makes so much difference in these graphs with a tremendous four-year performance by the equities from 1995 to 1998.

From this, one can make the argument that a payout rate between four percent and 4.5% is not “too high,” at least from the point of view of the current beneficiary. Two caveats need to be added at this point. First, this only considers the upper limits of what may be optimal for the current beneficiary, not the remaindermen. Obviously, lower is better for the remaindermen. Also, if the trust pays all of the capital gains tax, rather than sharing the obligation with the current beneficiary, a somewhat lower payout rate would be indicated, perhaps .25% less for a trust with a fresh start cost basis, and .60% to .75% less for one with a very low cost basis. This does give us some guidance on what might be “best” for the current

beneficiary. Remember, if the income from a given payout rate is the greatest in the last year, a lower rate would have produced less dollars in each and every prior year of the period since a lower rate always compares most favorably at the end of the period.

D. Asset Allocation Critically Affects Sustainability of the TRU Rate:  
Twice the Equities May Allow Twice the Payout!

In selecting a payout rate, one should understand that if the goal is to protect the trust estate and the distribution from future inflation, then the amount that one can afford to pay out is related directly to the asset allocation, and consequentially, the risk tolerance of the investor. To illustrate this, consider the case of Substantial Samantha and Little Lyle, whose estate assets appear as follows:

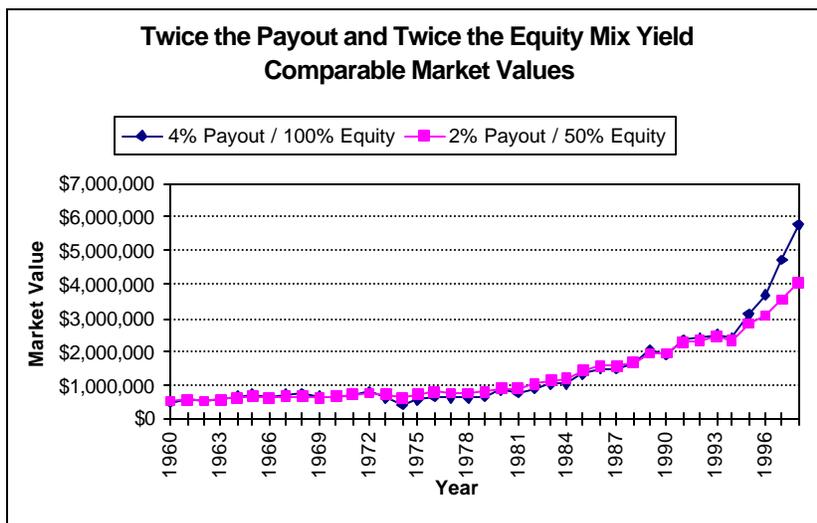
	<u>Substantial Samantha</u>	<u>Joint</u>	<u>Little Lyle</u>
Cash		\$ 500,000	
Municipals	\$ 2,000,000		\$ 500,000
Stocks	23,000,000		2,500,000
Residence		1,000,000	
Vacation Residence	_____	<u>500,000</u>	_____
	\$25,000,000	\$2,000,000	\$3,000,000

Samantha and Lyle are perfectly willing to give away some of their property, and the planner, therefore, suggests perpetuities trusts (or perpetual trusts, if you live in one of the increasing number of states abolishing the rule against perpetuities.)<sup>93</sup> To maximize the benefit of the GST exemption, the planner might suggest that they skip the first generation entirely or at least use a fully discretionary sprinkle trust so that the children could use an amount as small as possible from these trusts. However,

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<sup>93</sup> See Ira Mark Bloom, *The GST Tax Tail is Killing The Rule Against Perpetuities*, 87 TAX NOTES 569, 571-572 n.23 (2000) (pointing out that Alaska, Delaware, Idaho, Illinois, Maine, Maryland, New Jersey, Ohio, Rhode Island, South Dakota, Virginia, and Wisconsin have either repealed their Rule Against Perpetuities or have an "opt out" statute).

Samantha and Lyle do not want to do that.<sup>94</sup> They want their children to have a significant benefit from these trusts during their lifetimes, and they wish to take advantage of the GST exemption as early as possible. Lifetime gifts will be more effective because this makes the best use of their applicable credit amounts and should allow the trust to grow during their lifetimes. However, what if the children are unlike their parents and are very risk averse, so that they would be uncomfortable with anything more aggressive than a fifty/fifty portfolio? How would this interplay with the selection of a rate for the TRU trust for their children and their issue? Examining the effect of different payouts and asset allocations on each other, we might suggest that a four percent payout with an all-equity

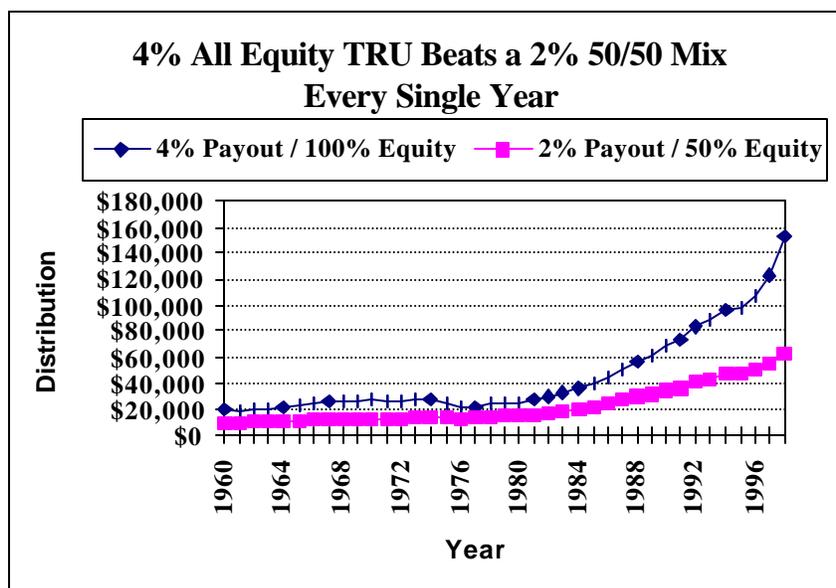


portfolio be compared with a two percent payout with a fifty/fifty portfolio. The graph below shows market values of that trust from 1960 through 1998.

Comparing the market values of the two trusts, one is tempted to conclude that the two trusts protect the principal value roughly equally

<sup>94</sup> Surprisingly, clients, given an opening, will express a desire for trust designs markedly different from what planners think is best for them!

throughout the period and that they protect it rather well. A closer look indicates that during the period of the 1970s, the all-equity trust dipped and stayed somewhat below the more conservative payout and did not catch up completely until 1989. Then again, from 1995 through 1998, the all-equity trust forged ahead by almost fifty percent, but using this ending period may be unrepresentative. One might conclude that overall the two trusts had similar characteristics from the point of view of protecting the GST exemption and consequently the grandchildren and their issue. However, now consider the distributions to the children and how they differ.



From this one sees the price of conservatism in the investment of the trust. At no point during the entire thirty-eight-year history would the current beneficiary have been in a better position with the more conservative two percent payout and the more conservative asset allocation. One is drawn to conclude that the current beneficiary's interest in the trust is worth perhaps twice as much invested in all equities than it is worth with the more conservative payout and more conservative investment mix. However, in the design phase of the trust, one may need to consider the conservatism of the trustee and beneficiary in determining what rate is appropriate, at least if one is to preserve a rational expectation

of meeting the goal of inflation protection, which is likely to be the client's goal in this situation.

So once again, asset allocation is the key.

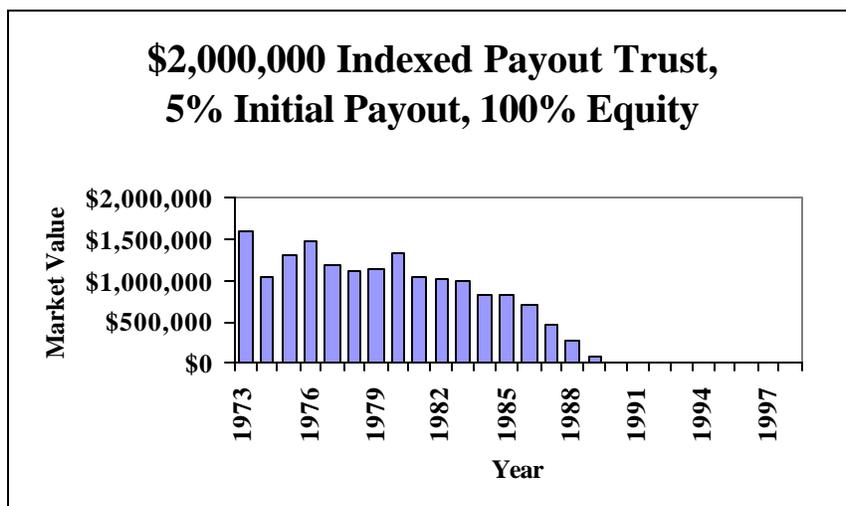
#### E. Total Return Trusts: Fill the Planner's Tool Chest with the Right Tools for the Right Job

No one type of trust fits all situations. Like the craftsman, the estate planner should consider all available tools to match the particular job in a particular family. This section considers a difficult situation that allows us to test both old and new tools to see which ones fit the job.

##### 1. *Dealing With the High Demand, High Risk Scenario*

Consider the case of Rex Ready and Willing Wilma. Rex is getting remarried to Wilma, and they are negotiating their prenuptial agreement. Rex has been an entrepreneur for many years and has involved his children by his first marriage in the business. Obviously, he would like to protect his small business and also wants to satisfy the needs of his new wife, Wilma. Wilma believes that she needs to have \$100,000 in income from Rex's estate plan in the event of his death to counter the loss of his earnings. She also wants that income to keep up with inflation. Rex is seventy-eight years old, Wilma is seventy-three. Rex has a total of \$2,000,000 in assets that could be placed in the trust without including his business.

What type of a trust can we offer to Wilma? The first and most obvious suggestion would be to use an indexed payout trust starting at five percent of the initial fair market value or simply \$100,000 indexed for inflation and see if that would accommodate Wilma's needs. Unfortunately, if at the time of Rex's death, they experience a period of high inflation and a bear market, as we did starting in 1973, the trust may be depleted entirely during Wilma's lifetime, thus protecting neither Wilma in



the long run nor the children's interests. The following is a chart of the market value of that indexed payout trust beginning in 1973:

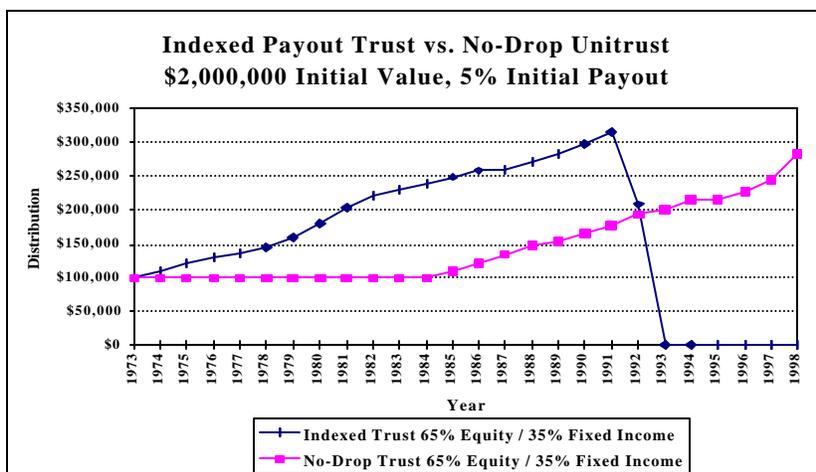
This would not be an acceptable risk for either Wilma or Rex. Under this bearish scenario, the trust would be depleted in eighteen years.

## 2. *What About a Hybrid: A "No-Drop" Unitrust*

If the first tool does not work, perhaps the planner can find another in the toolbox to address Rex and Wilma's problem. What if one were to design a trust that would not allow the distribution to go down (a "no-drop" unitrust), but would allow it to go up if the market provided enough return? No theoretical difficulty exists. The planner simply could insert the following language into the form:

The distribution amount shall not be less than the distribution amount in the immediately preceding tax year of the trust, except in the case of a short year, or in an adjustment year, or the year immediately following an adjustment year where the adjustment is caused by an additional distribution from the trust as set forth below. In such case, the distribution amount can decrease but only by the amount of the adjustment or, in the case of the following year, by the distribution rate multiplied by the additional distribution as set forth below.

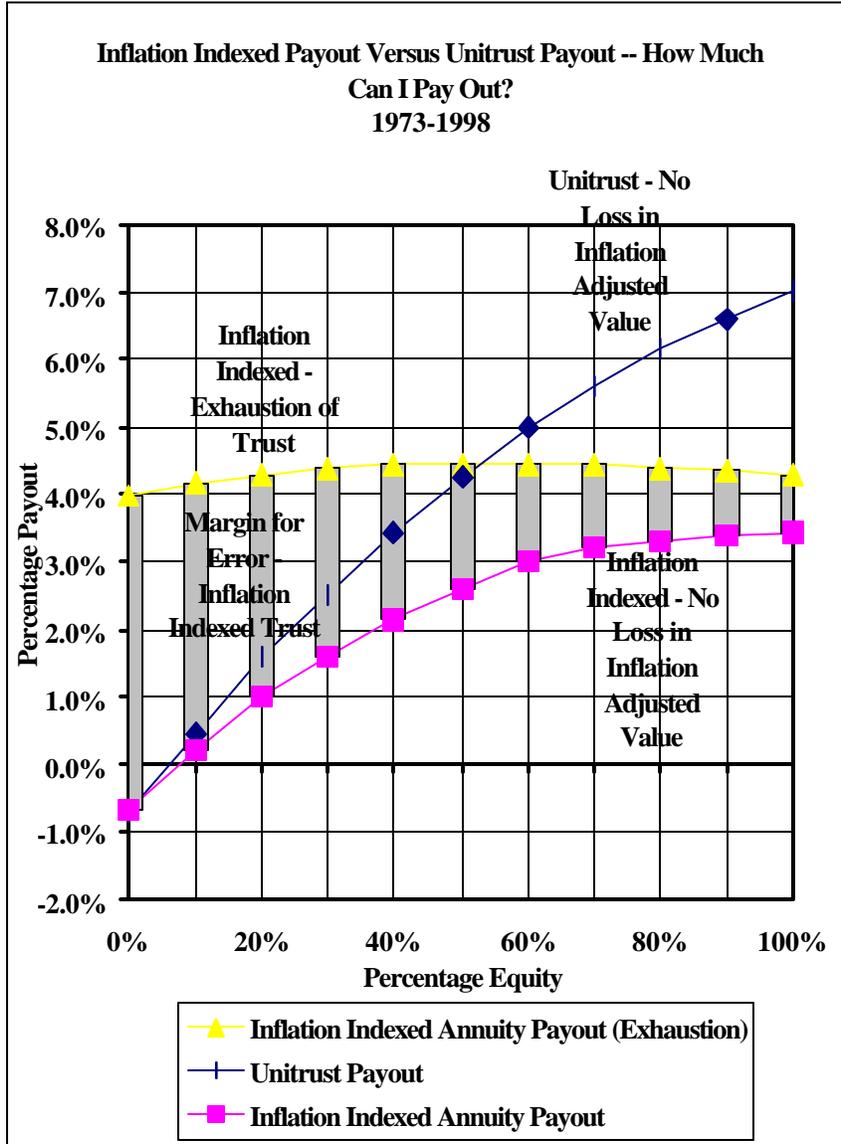
Might this satisfy Wilma by having no possibility that it would decrease and yet the possibility that it could increase with inflation? Guaranteeing that the trust distribution will not go down is going to be significantly safer in most scenarios than an indexed payout trust, but it may not do the job that Wilma thinks it should. Again, using the difficult 1973 starting date, the following graph represents the payouts from an indexed payout trust and a no-drop unitrust, each with a conservative sixty-five percent equity and thirty-five percent fixed income investment mix.



Though the no-drop unitrust is far safer than the indexed payout trust, even with the more conservative portfolio, Wilma's distribution will not increase for a full ten years. Of course, this is because, during this bear

market, the overall portfolio decreased significantly in value during this period. A tremendous gap exists between the indexed payout Wilma desires and what may be provided by a no-drop unitrust. What percentage would prevent exhausting the trust as compared to preserving its real value? See Graph on page 220.

Clearly, some margin for error exists in the indexed payout trust, but not enough to get us up to Wilma's request for a five percent indexed payout. Interestingly, the highest payout rate seems to be afforded by about a fifty/fifty mix. This is due to the relatively greater tolerance of a more conservative portfolio for combined effects of a bear market and an indexed payout during an inflationary cycle. If our goal was to have no loss in value during this period, one would be able to pay out no more than about 3.4% with an all-equity portfolio. At 4.2% the trust is exhausted. Note that when the goal is no loss in value, over long periods of time the trust is always better off with the highest percentage of equities, whereas when the fear is exhaustion of the trust, fixed income is an important ingredient.



The graphic results of comparing the no-drop unitrust versus the total return unitrust for the same period are shown on page 222.

The no-drop unitrust has a much greater margin for error, so we could offer Wilma a much higher “starting salary” if she and the rest of the family and the children by Rex’s first marriage were willing to accept the attendant risks. With an ordinary unitrust the risk depletion is essentially zero<sup>95</sup> but that is not so with a no-drop unitrust as the graph illustrates. In most scenarios, the use of the no-drop unitrust will not cost much in terms of what can be paid out, but one scenario exists in which it would—a deflationary depression such as in the 1930s. In that case the inflation indexed payout trust would be safer than a no-drop unitrust because the distributions would be reduced automatically during a period of deflation, which would, relatively speaking, protect the trust corpus from depletion. Indeed, a five percent indexed payout trust that was funded with \$100,000 in 1926 would have \$228,336 at the end of 1998 even with the “safer” sixty-five percent equity/thirty-five percent fixed-income portfolio.<sup>96</sup> This is due to the fact that the dividend payout at the beginning was 5.41%, and dividends, as discussed later, historically have done an excellent job of keeping up with inflation. Critically, though, the reason it worked is that the first truly awful market was one that experienced deflation rather than inflation.

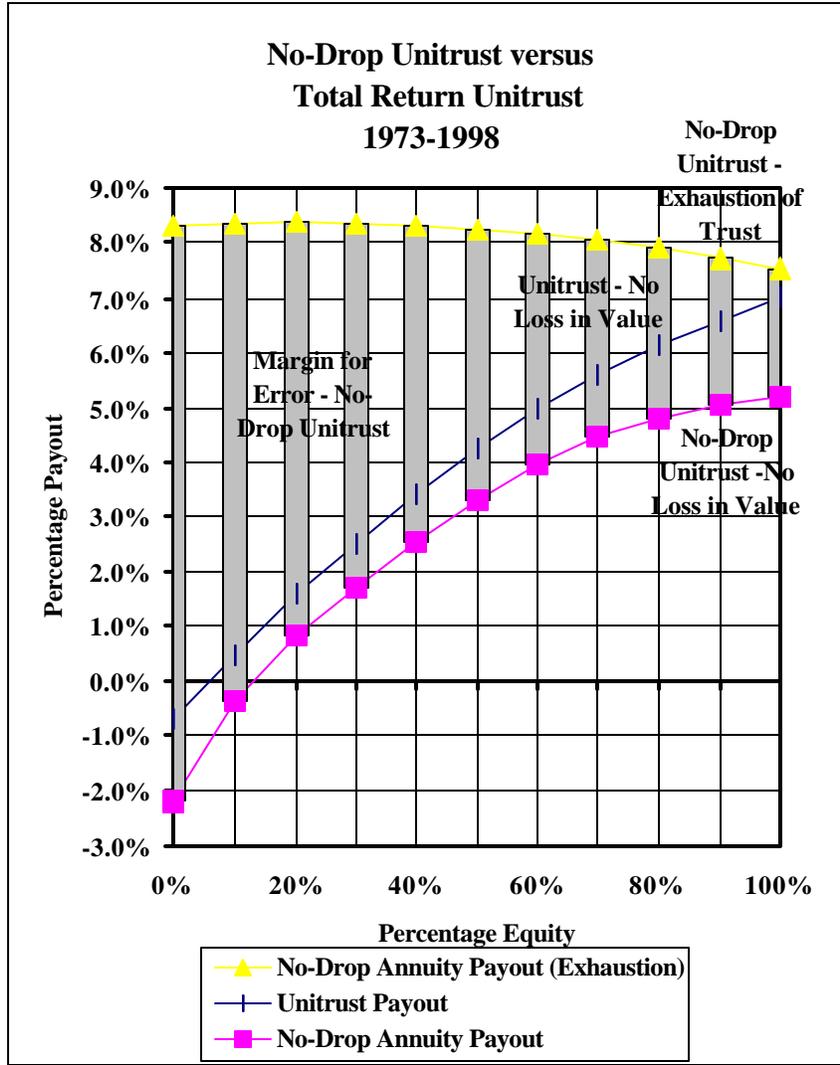
The foregoing illustration uses a sixty-five/thirty-five mix to be safer. If it had been all equity, \$7,252,903 would be in the trust at the end of 1998.<sup>97</sup> How did it get so large? The distribution on the \$7,250,000 trust in 1998 is \$45,000, only .6% of the ending value. Now that’s leverage. That is also risk.

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<sup>95</sup> The risk of depletion occurs because of the smoothing rule, but within any reasonable range of payouts, it cannot deplete itself, since the payout decreases with the portfolio’s loss in value.

<sup>96</sup> This should not be mistaken for a good result because \$228,336 in nominal dollars equals \$25,383 in 1926 dollars. This trust would have been paying out almost twenty percent of its current market value in 1998. It would now be on its way to extinction, even after surviving all of those years, given the results in 2000 and thus far in 2001.

<sup>97</sup> In 1926 dollars, the value would be \$806,280, over eight times the original value, and thirty-two times the amount remaining with an indexed payout trust.



3. *A Merger of Good Ideas: The TRUCAP Index Trust*

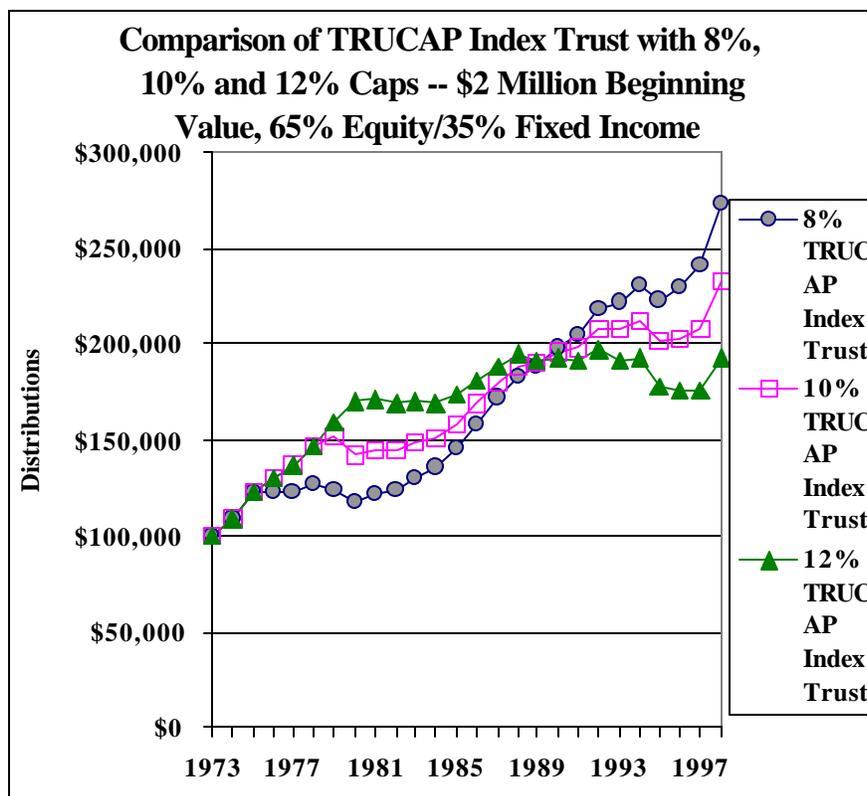
This case study highlights both the great advantage and the great disadvantage of the indexed payout trust. Once we unlink the payout from the total return earned in a trust and from its market value, we risk depletion of the trust. If we link the payout to the market values, clearly we will fall well short of our goal in this example of keeping Wilma up with inflation. Of course, setting a goal of keeping up with inflation starting at five percent and beginning the trust in 1973 makes the goal impossible to reach. Could we design a trust payout that would better blend the priorities so as to try to match the distribution with inflation but impose safeguards on the distribution to avoid depleting the trust?

The answer may be a hybrid between the TRU and the indexed payout trust. If one employs an indexed payout formula, a limit is placed upon it so that the payout must relate sensibly to the market value, and one could avoid the risk of complete depletion of the trust during the beneficiary's lifetime. Obviously, depletion is the worst-case scenario. What would the distributions look like in this case study if a cap were placed on the distribution at ten percent times the average of the fair market values of the trust over the most recent three-year period?

Doing this creates a hybrid between the indexed payout trust and the TRU so that, during "normal" or good times, the trust would distribute the indexed payout; however, if the indexed payout exceeded the ten percent benchmark, the trust would distribute only the ten percent TRU distribution, putting a "cap" on the payout. This effectively would convert the trust from an indexed payout trust into a TRU only when the trust assets need the protection of a spending methodology that is geared to what is available. The three year smoothing rule should be used here on the "TRUCAP" for the same reason it is in the ordinary TRU. Without the three year smoothing rule, the trust would otherwise act as a high rate unitrust without a smoothing rule during difficult market periods. This is likely to be particularly disquieting for a trust beneficiary because of the volatility that it would produce.

Ten percent was chosen after modeling a number of other rates. The closer the cap rate is to the initial distribution rate, the more the TRUCAP index trust will resemble the unitrust. This method of distribution will work well in typical markets but is severely tested in our worst case scenario.

Below a graph illustrates the distributions from our TRUCAP trust using a sixty-five percent equity/thirty-five percent bond portfolio from 1973 through 1998 and alternative eight percent, ten percent, and twelve percent caps.

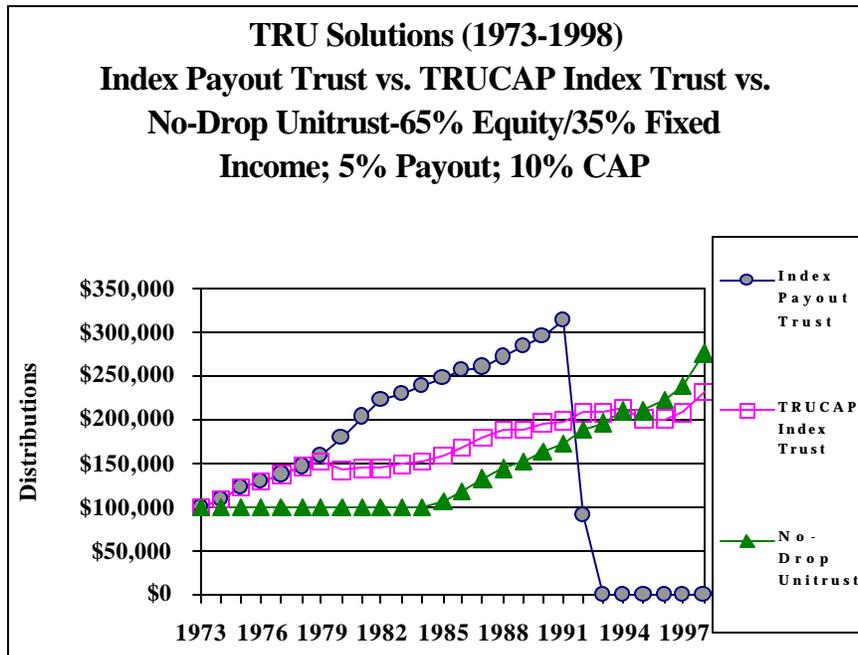


The distributions from the ten percent cap rate take a middle ground between the eight percent and twelve percent caps. In this a very difficult scenario, the ten percent cap would allow the trustee to pay out the inflation indexed value for a period of six years before the trust converts itself into a ten percent unitrust with a three year smoothing rule. From that point on, it is a ten percent TRU. This is an aggressive payout, but, in this worst-case scenario, it allows the trustee to make some real progress throughout Wilma's remaining lifetime, despite difficult markets and a high payout rate.

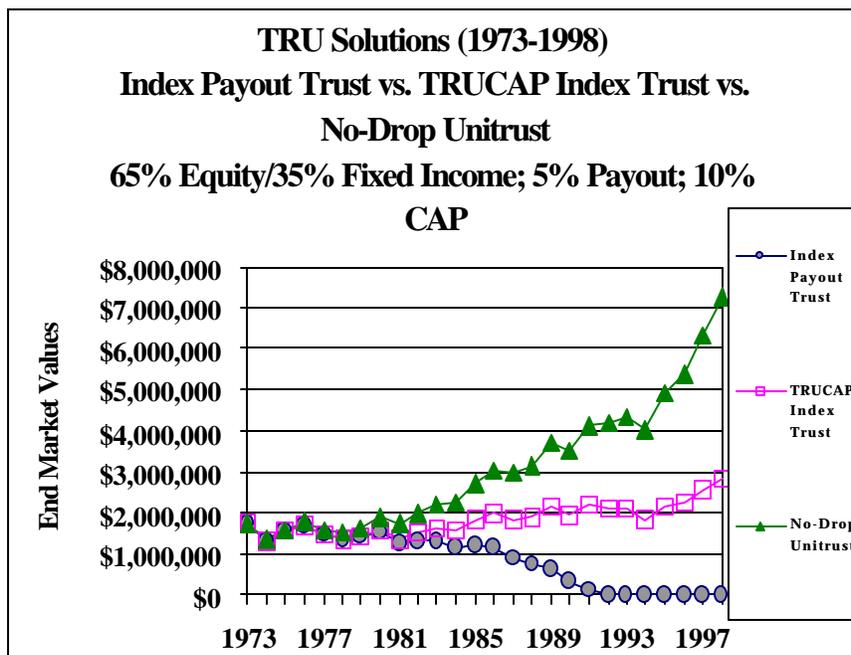
Returning to our distribution comparison, the Article compares our new model with the indexed payout trust and the no-drop unitrust. See the graph below.

This may be the best way to accomplish Wilma’s dual goals of keeping the distribution up with inflation and not exhausting the trust, which would place Wilma in even greater financial difficulty.

While the TRUCAP alternative does not appear to get all that close to the inflation-protected goal, one must remember that we are testing this case study in a period when the goal cannot be attained because of the combination of inflation and the bear market. In any true estate plan, the planner does not know whether we are approaching a period like 1973 or a period more like 1951 or 1981, when the near future offers plentiful rewards for the investor. Even more telling is the fact that most trusts go into effect at the grantor’s death, which is often many years in the future.

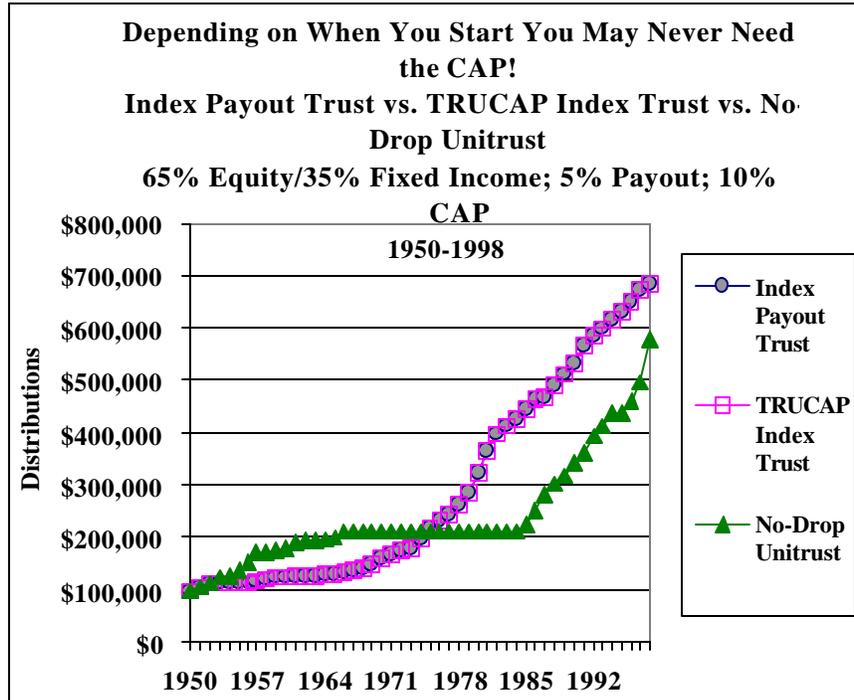


We simply do not know what the future will bring, and we are testing these models in the past to gain insight into the relative safety of this approach. Before ending discussion on this potential solution, let us consider the ending market values from the three models.



The ten percent TRUCAP index trust was trading water even in nominal terms throughout this period. Putting a cap higher than ten percent would increase the danger to the financial security of Wilma and the children.

The result depends on when we start our model. If one were to begin the analysis in 1950 and compare these same three trusts with payouts beginning at five percent, the resulting graph on the following page reminds us of the uncertainty of the future and the substantial difference produced depending upon the starting and stopping points of our analysis.



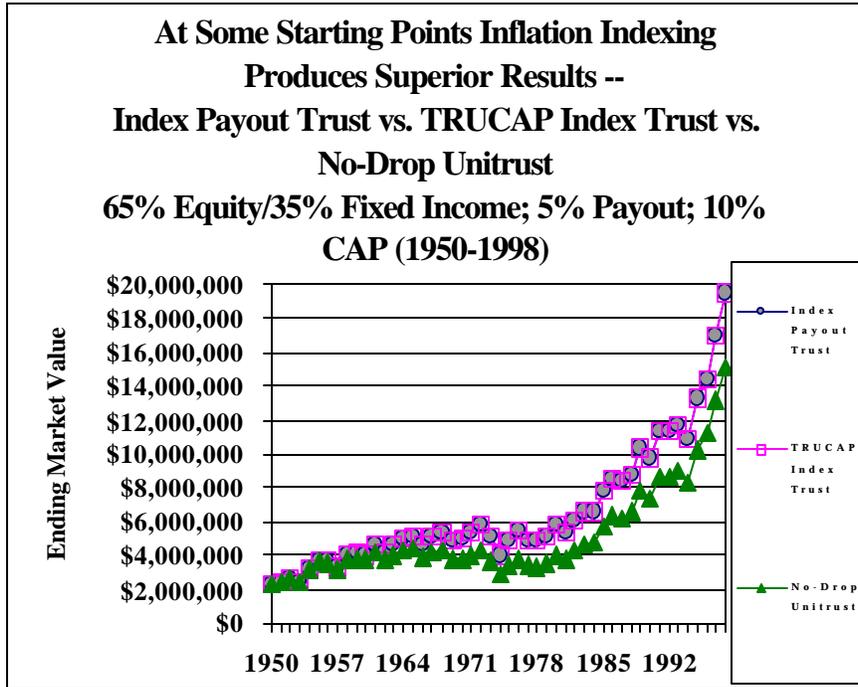
In this illustration, the TRUCAP never comes into play. The 1950s were such a good economic period from the point of view of low inflation and a high equity return that the trust builds up its value. Therefore, in the 1970s, the distribution can keep up with inflation without distributing more than ten percent of the smoothed market values from the trust. Note the significant difference in the no-drop configuration that runs into trouble in 1966 because the S&P 500 attained its high water mark, taking into account the burgeoning inflationary pressures. Because the no-drop paid out significantly more during the 1950s and 1960s, up to that point, it would otherwise be declining in value, and therefore, in distribution, if not for the “no-drop” rule. The no-drop does not regain its upward momentum until 1985. If we were to graph the market values from the two trusts, we would find that the TRUCAP index trust maintained the value of the trust better than the no-drop unitrust. See graph on page 229.

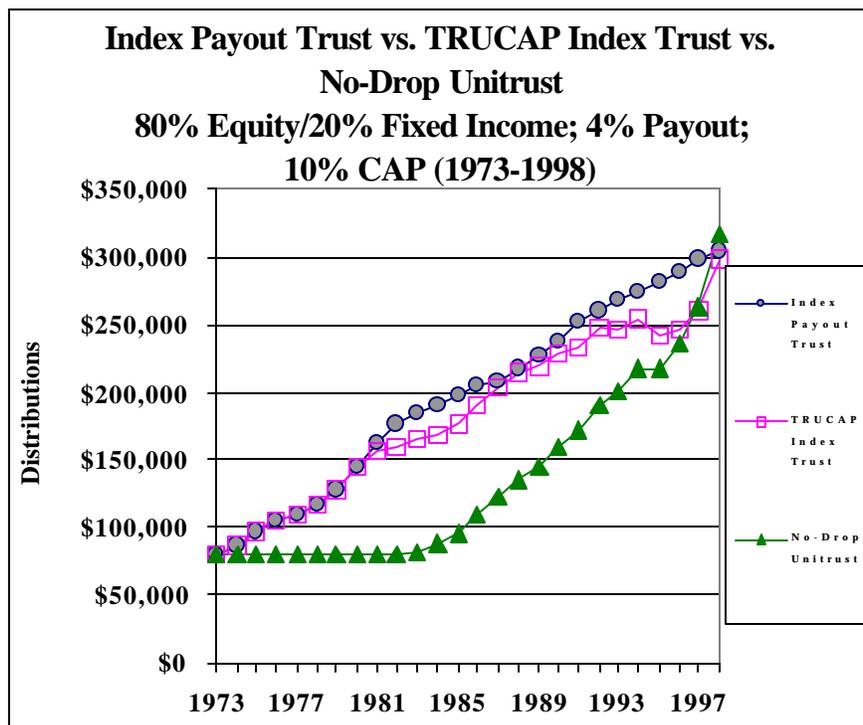
Starting with 1950, a highly favorable starting point as contrasted with 1973, reveals very different results and comparisons of our trust models. The strength of the TRUCAP index trust is that it can potentially change back and forth from an index trust to a unitrust as necessary and as possible, given the market and economic conditions. If we compare the same three trusts starting in 1973 but using a four percent payout rate initially and an eighty percent equity/twenty percent fixed income investment mix, the results are shown on the graph on page 230.

The TRUCAP index trust first acts as an indexed payout trust for eight years, then becomes a ten percent TRU for the remainder of the period but closely approaches the indexed payout goal in 1989 and in 1998. Having a trust which can morph back and forth may be helpful in this type of difficult planning scenario.

#### 4. *Choosing Your Risks: The Inflation-Depletion Dichotomy*

If one is willing to accept the variability in distribution to which it is subject, a TRU trust is the safest trust distribution methodology from the point of view of protecting, and not exhausting, the trust principal. The TRU is safer than a no-drop unitrust because it is safe from depletion even in a deflationary depression.





The TRU is safer than an indexed payout trust because it is protected from depletion even in an inflationary bear market, perhaps the most likely worry today. Of course, the income rule trust is also safe from depletion, but it is also subject to all of the conflicts and limitations on investment selection and performance discussed earlier in this Article and the author's prior articles.

The TRUCAP index trust, however, is probably the vehicle of choice given the very high priority on keeping Wilma's income up with inflation. It will not protect the principal value of the trust as well as the unitrust, but because we do not know what the *next* economic period will look like, it provides what may be a relatively ideal hybrid between the two trusts.

The tool that the planner decides to use and the payout rate have important implications for the investment of the trust. When depletion is more of a problem, fixed income plays a more important role; whereas, if the goal is to keep the trust up with inflation, in all long historical periods, equities are the superior investment. The allocation of risk and return varies significantly depending upon our choice of distribution methodology and is sensitive particularly once we stray from the path of an income interest or a unitrust interest. Consequently, the type of trust planners choose must be taken into account in investing the trust as well.

#### 5. *Asset Sufficiency and Certainty*

The foregoing difficult case study sought to satisfy Wilma's need for both security and protection from inflation by inventive trust design, but we could also analyze the case study from the point of view of asset sufficiency. Wilma was seventy-three years old and in thirty years she would be 103. Only a two percent possibility exists that she would be alive at the end of that period based on current actuarial tables. If we were to computer model a five percent indexed payout trust for all of the thirty-year rolling periods starting in 1926, in nineteen of the thirty-year or shorter periods Wilma would have run out of money.<sup>98</sup> This is an unacceptable number of failures but if we did the same thing with a four percent payout, she would have run out of money in only four of the forty-eight periods, a ninety-two percent success rate. If we had lowered the payout rate to 3.5%, the trust would not have been exhausted in any of the forty-eight starting years from 1926 to 1973. The probability of being able to use an inflation indexed payout will vary directly depending on its initial payout. If additional capital were required, life insurance could be added to change the odds of success as follows:

	<u>5%</u>	<u>4%</u>	<u>3½%</u>
Wilma's Success			
Rate:	60%	92%	100%

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<sup>98</sup> The trust would be exhausted with a 65/35 investment mix in the periods starting in 1971, 1972 and 1973, so these shorter periods were included as well.

Insurance needed to fund trust	0	\$500,000	\$860,000
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The additional insurance needed is simple to compute. We work backwards from the required income, dividing it by the payout rate, and arrive at the capital required. The difference between the capital required and the capital available is the amount of additional life insurance needed to increase our odds to a level of comfort. Though no approach will produce a 100 percent guarantee, one of the most important tools that can be used in this type of difficult scenario is simply to increase the available trust assets with life insurance so that the payout rate can become safer and more secure.

#### F. How to Handle Three Trust GST Plans

The Article has examined all the trust tools needed to tackle a three trust GST plan. Assume that Successful Sylvester and Supportive Sally, our estate planning clients discussed previously, were to come back fifteen years later. Sylvester and Sally are now sixty-five years old and are considering retirement. Their children are in their thirties, and they currently have five grandchildren. Their assets appear as follows:

	Successful Sylvester	Joint	Supportive Sally
Cash and Securities	\$3,500,000	\$0	\$1,100,000
Residence		\$ 500,000	
Life Insurance	<u>\$ 250,000</u>	_____	<u>\$ 100,000</u>
Total	\$3,750,000	\$ 500,000	\$1,200,000
Total Assets		\$5,450,000	

While Sylvester and Sally have seen their portfolios grow comfortably, their lifestyle has increased as well; with the children out of the house, they are accustomed to having a few of the finer things. Sylvester and Sally have begun making annual exclusion gifts to their children, and in the event of Sylvester's death, Sally would want to be able to continue this practice, without feeling strapped. Consequently, they need \$180,000 in cash flow to do that and to keep Sally comfortable. They further advise that they would like to have some portion of their estate kept safe from taxes for at least two generations. Therefore, a three-trust plan should be considered, with the usual nonexempt marital trust, GST exempt marital trust, and credit shelter trust to which the GST exemption is applied. This would give us three trusts to design:

Credit Shelter Trust - \$675,000  
GST Exempt Marital Trust - \$355,000  
GST Nonexempt Marital Trust - \$2,720,000

Using the techniques we have learned, one would use the most aggressive investment mix and the most conservative payout regimen in the most tax advantaged trust, to focus the economic benefit entirely on the lowest generation. Making the credit shelter trust fully discretionary, planning to invest the credit shelter trust entirely in equities, and distributing nothing from that trust unless, or until, the other two trusts were exhausted would accomplish this. The GST exempt marital trust must, of course, pay out all the income,<sup>99</sup> but with a somewhat tax advantaged trust, we might wish to use a three percent marital TRU and a seventy-five/twenty-five equity/fixed income mix. The nonexempt marital TRU should be invested the most conservatively with the highest payout rate, in this case a 6.25% marital TRU. These three trusts will provide a total of slightly more than \$180,000 in cash flow, exactly what Sally wanted.

Now instead of modeling these three trusts for a specific period, let us look at all of the historical periods and examine their best and worst cases and their average results to study the effects of this plan. That way we will

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<sup>99</sup> Unless they live in a state with a statutory unitrust alternative, in which case they would have greater flexibility. See *supra* text accompanying notes 48-53.

have a better idea as to our risks and avoid any claims of “data mining.”<sup>100</sup> The relevant period to be examined would be twenty years, reflecting Sally’s remaining life expectancy. Let us look at the full results, counting all fifty-five of the relevant twenty year periods, beginning in 1926. The results for each of the trusts are as follows:

#### Total Return Trust Plan

##### Credit Shelter Trust — All Equity — No Payout

<u>Starting Value</u>	<u>Worst Case</u>	<u>Best Case</u>	<u>Average Result</u>
\$675,000	\$739,407	\$10,794,219	\$3,835,842

##### GST Exempt Marital Trust — 75 percent Equity — 3 percent Payout

<u>Starting Value</u>	<u>Worst Case</u>	<u>Best Case</u>	<u>Average Result</u>
\$355,000	\$261,382	\$2,139,901	\$853,974

##### GST Nonexempt Marital Trust

<u>Starting Value</u>	<u>Worst Case</u>	<u>Best Case</u>	<u>Average Result</u>
\$2,720,000	\$1,275,914	\$7,873,053	\$3,290,301

Several observations about the foregoing results jump out at the reader. First, a tremendous variation exists between the worst and best cases. As one would expect, the variability of the credit shelter trust invested in 100 percent equities is the greatest. The average results in the three trusts illustrate quite well the expected results with the following average increases in market value:

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<sup>100</sup> The process of data mining can be described as digging through large volumes of data until we find some data that is favorable to our study, and then citing only that data.

<u>Credit Shelter Trust</u>	<u>GST Exempt Marital Trust</u>	<u>GST Nonexempt Marital Trust</u>
468 % Increase	141 % Increase	17 % Increase

This, of course, is exactly what one intends with twenty-seven times the increase in the most highly taxed credit shelter trust than we have to the GST nonexempt marital trust. The methodology remains true even in the worst case which, surprise to no one, begins in 1929:

Change in value 1929-1948

<u>Credit Shelter Trust</u>	<u>GST Exempt Marital Trust</u>	<u>GST Nonexempt Marital Trust</u>
+9.5%	-26 %	-53 %

Even in the worst-case scenario in recorded financial history, the methodology produces a favorable result from a tax planning point of view. Interestingly, as you might suspect, a higher fixed income mix would have been optimal starting in 1929. In fact, a thirty-one percent equity sixty-nine percent fixed income portfolio would have given us the highest value at the end of the 1929 to 1948 period —\$1,016,685 on the credit shelter trust.<sup>101</sup>

If a conventional plan of trying to match income with desired distribution had been followed, the investment mix needed to produce the desired 4.8% yield using year 2000 rates would have to have been eighty-four percent fixed income, as represented by a thirty-year U.S. Treasury Bond and sixteen percent equities. If one were to use all income rule trusts, the results would be:

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<sup>101</sup> While bonds had the higher total return than stocks during that period (3.9% versus 3.1%), the annual re-balancing produces the highest ending balance with thirty-one percent equities.

## Income Rule Trust Plan

## Credit Shelter Trust

<u>Starting Value</u>	<u>Worst Case</u>	<u>Best Case</u>	<u>Average Result</u>
\$675,000	\$503,392	\$1,025,352	\$733,830

## GST Exempt Marital Trust

<u>Starting Value</u>	<u>Worst Case</u>	<u>Best Case</u>	<u>Average Result</u>
\$355,000	\$264,747	\$539,259	\$385,940

## GST Nonexempt Marital Trust

<u>Starting Value</u>	<u>Worst Case</u>	<u>Best Case</u>	<u>Average Result</u>
\$2,720,000	\$2,028,483	\$4,131,789	\$2,957,064

The average increases in value are as follows:

	<u>TRU Plan</u>	<u>Income Rule Trust</u>
Credit Shelter Trust	+468%	+8.7%
GST Exempt Marital Trust	141%	+8.7%
GST Nonexempt Marital Trust	17%	+8.7%

The net to the next generation, after taxes at fifty percent in the surviving spouse's estate, would be as follows:

## Average Results

## TRU Three Trust Plan

	<u>Pre-Tax</u>	<u>Tax</u>	<u>After Tax</u>
Credit Shelter Trust	\$3,835,842	\$ 0	\$3,835,842
GST Exempt Marital Trust	\$ 853,974	\$ 426,987	\$ 426,987
GST Nonexempt Marital Trust	<u>\$3,290,301</u>	<u>\$1,645,151</u>	<u>\$1,645,150</u>
Total	\$7,980,117	\$2,072,138	\$5,907,979

## Income Rule Trust Plan

	<u>Pre-Tax</u>	<u>Tax</u>	<u>After Tax</u>
Credit Shelter Trust	\$ 733,830	\$ 0	\$ 733,830
GST Exempt Marital Trust	\$ 385,940	\$ 192,970	\$ 192,970
GST Nonexempt Marital Trust	<u>\$2,957,064</u>	<u>\$1,478,532</u>	<u>\$1,478,532</u>
Total	\$4,076,834	\$1,671,502	\$2,405,332

Hence, the average after tax results to the next generation are two and a half times as large using the TRU three-trust plan over the average of all twenty year periods since 1926. The actual rolling period data is shown in the table below:

<b>TABLE</b>			
Credit Shelter TRU	GST Exempt Marital TRU	GST Non-Exempt Marital TRU	
Equity %: 100%	Equity %: 75%	Equity %:	50%
Fixed Income %: 0%	Fixed Income %: 25%	Fixed Income %:	50%
Income Tax Rate: 38%	Income Tax Rate: 38%	Income Tax Rate:	38%

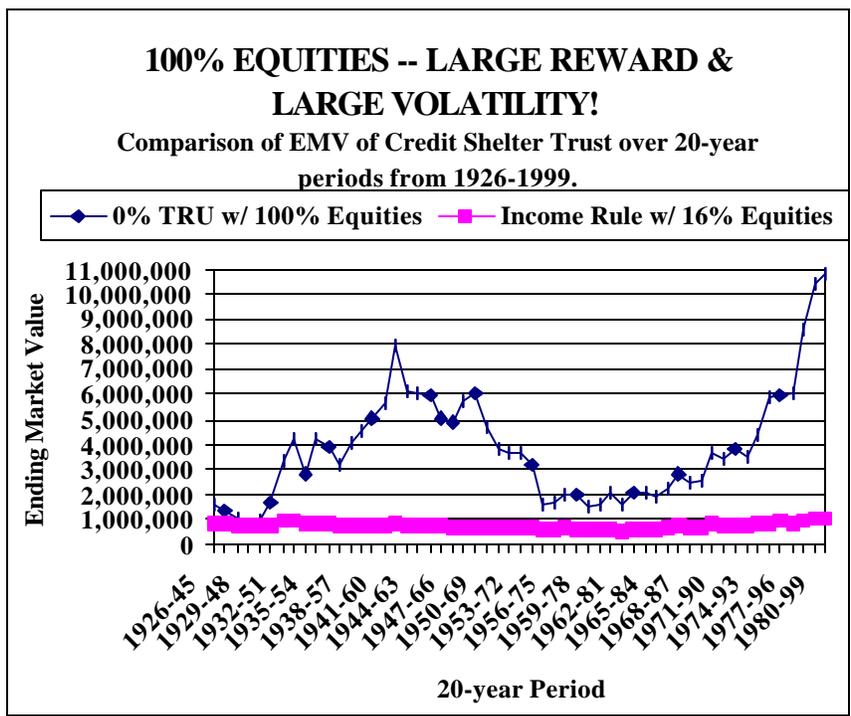
Capital Gain Rate:22%	Capital Gain Rate:22%	Capital Gain Rate:	22%
Expense Rate: 1.00%	Expense Rate: 1.00%	Expense Rate:	1.00%
Turnover Rate: 5.00%	Turnover Rate: 5.00%	Turnover Rate:	5.00%
Cost of Turnover:50%	Cost of Turnover:50%	Cost of Turnover:	.50%
Payout Rate: 0%	Payout Rate 3.00%	Payout Rate:	6.25%
Begin MV: \$675,000	Begin MV: \$355,000	Begin MV:	\$2,720,000
Credit Shelter TRU	GST Exempt Marital TRU	GST Non-Exempt Marital TRU	
20-Year Period EMV	20-Year Period EMV	20-Year Period	EMV
1926-1945 1,548,728	1926-1945 469,950	1926-1945	2,035,385
1927-1946 1,291,149	1927-1946 409,145	1927-1946	1,811,821
1928-1947 1,004,045	1928-1947 333,827	1928-1947	1,533,036
1929-1948 739,407	1929-1948 261,382	1929-1948	1,275,914
1930-1949 942,158	1930-1949 308,717	1930-1949	1,442,070
1931-1950 1,620,339	1931-1950 452,795	1931-1950	1,900,331
1932-1951 3,300,382	1932-1951 763,786	1932-1951	2,865,684
1933-1952 4,204,077	1933-1952 906,214	1933-1952	3,153,002
1934-1953 2,777,414	1934-1953 656,873	1934-1953	2,471,296
1935-1954 4,211,066	1935-1954 900,752	1935-1954	3,057,776
1936-1955 3,856,678	1936-1955 832,349	1936-1955	2,763,656
1937-1956 3,115,199	1937-1956 697,648	1937-1956	2,382,254
1938-1957 4,080,111	1938-1957 847,475	1938-1957	2,835,590

Credit Shelter TRU		GST Exempt Marital TRU		GST Non-Exempt Marital TRU	
20-Year Period	EMV	20-Year Period	EMV	20-Year Period	EMV
1939-1958	4,530,698	1939-1958	913,172	1939-1958	2,881,494
1940-1959	5,071,274	1940-1959	984,545	1940-1959	3,019,472
1941-1960	5,589,584	1941-1960	1,074,567	1941-1960	3,331,467
1942-1961	7,933,319	1942-1961	1,419,408	1942-1961	4,066,203
1943-1962	6,127,921	1943-1962	1,189,421	1943-1962	3,600,703
1944-1963	6,060,698	1944-1963	1,183,304	1944-1963	3,510,895
1945-1964	5,969,354	1945-1964	1,182,110	1945-1964	3,499,127
1946-1965	5,028,065	1946-1965	1,028,347	1946-1965	3,122,758
1947-1966	4,847,597	1947-1966	999,474	1947-1966	3,156,521
1948-1967	5,697,937	1948-1967	1,134,446	1948-1967	3,450,746
1949-1968	6,013,093	1949-1968	1,196,718	1949-1968	3,596,951
1950-1969	4,732,233	1950-1969	992,161	1950-1969	3,086,488
1951-1970	3,833,928	1951-1970	883,632	1951-1970	2,916,571
1952-1971	3,602,864	1952-1971	866,669	1952-1971	2,908,072
1953-1972	3,677,604	1953-1972	894,851	1953-1972	2,991,860
1954-1973	3,175,638	1954-1973	803,383	1954-1973	2,799,696
1955-1974	1,588,993	1955-1974	475,382	1955-1974	1,930,955
1956-1975	1,692,067	1956-1975	503,938	1956-1975	2,032,725
1957-1976	1,964,462	1957-1976	577,540	1957-1976	2,358,618
1958-1977	2,005,402	1958-1977	566,990	1958-1977	2,341,213
1959-1978	1,528,641	1959-1978	455,676	1959-1978	2,005,718
1960-1979	1,612,619	1960-1979	470,425	1960-1979	2,101,242

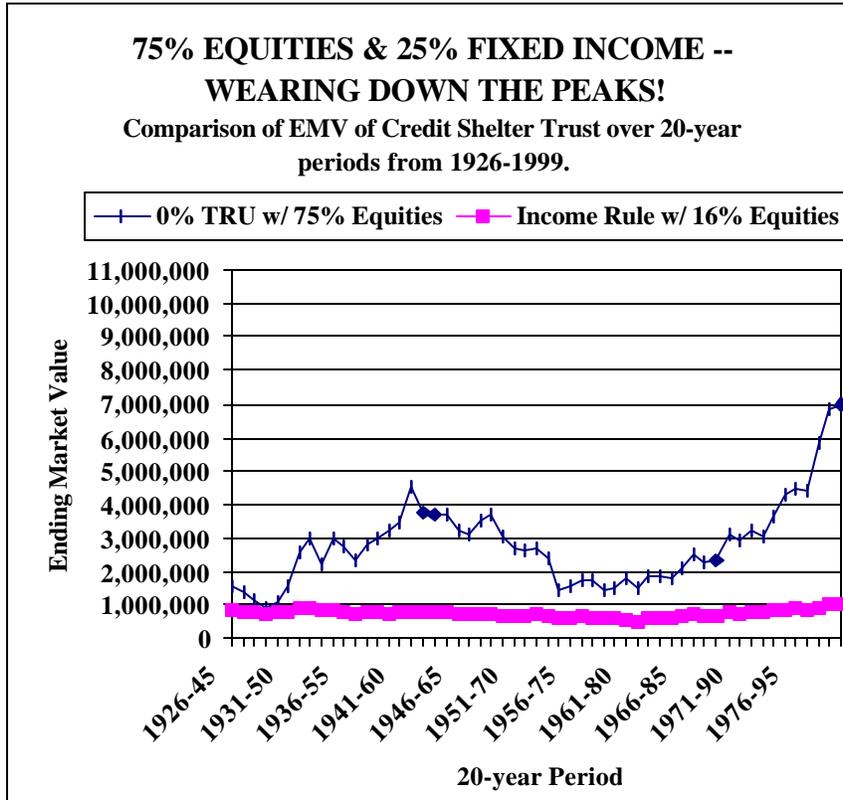
Credit Shelter TRU		GST Exempt Marital TRU		GST Non-Exempt Marital TRU	
20-Year Period	EMV	20-Year Period	EMV	20-Year Period	EMV
1961-1980	2,092,869	1961-1980	555,125	1961-1980	2,317,407
1962-1981	1,586,846	1962-1981	439,676	1962-1981	1,988,882
1963-1982	2,047,121	1963-1982	543,469	1963-1982	2,485,874
1964-1983	2,059,188	1964-1983	543,725	1964-1983	2,519,241
1965-1984	1,881,894	1965-1984	503,924	1965-1984	2,485,733
1966-1985	2,205,103	1966-1985	579,931	1966-1985	2,894,502
1967-1986	2,835,042	1967-1986	718,056	1967-1986	3,534,641
1968-1987	2,448,789	1968-1987	633,849	1968-1987	3,263,998
1969-1988	2,574,003	1969-1988	652,628	1969-1988	3,387,365
1970-1989	3,618,611	1970-1989	872,928	1970-1989	4,386,104
1971-1990	3,356,177	1971-1990	807,481	1971-1990	4,088,076
1972-1991	3,834,869	1972-1991	902,419	1972-1991	4,501,322
1973-1992	3,483,005	1973-1992	840,624	1973-1992	4,340,851
1974-1993	4,384,647	1974-1993	1,014,417	1974-1993	5,074,815
1975-1994	5,840,985	1975-1994	1,221,939	1975-1994	5,532,152
1976-1995	5,970,429	1976-1995	1,289,059	1976-1995	5,792,586
1977-1996	6,013,115	1977-1996	1,281,304	1977-1996	5,544,780
1978-1997	8,569,535	1978-1997	1,724,360	1978-1997	6,919,842
1979-1998	10,400,127	1979-1998	2,066,658	1979-1998	7,873,053
1980-1999	<u>10,794,219</u>	1980-1999	<u>2,139,901</u>	1980-1999	<u>7,820,019</u>
Average	3,835,842	Average	853,974	Average	3,290,301
Best	10,794,219	Best	2,139,901	Best	7,873,053

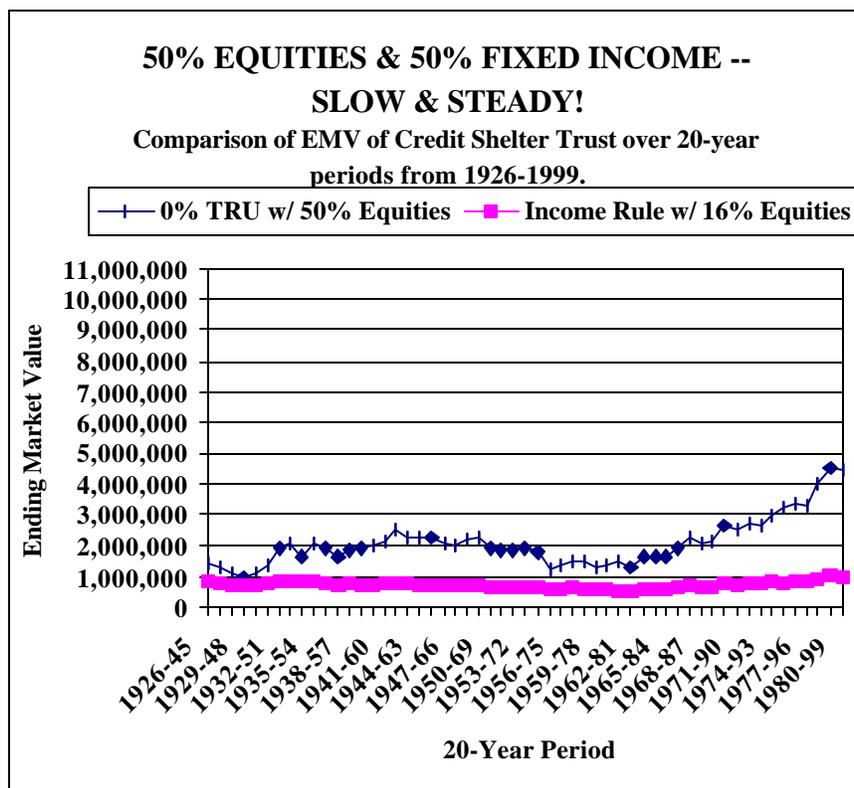
Credit Shelter TRU		GST Exempt Marital TRU		GST Non-Exempt Marital TRU	
20-Year Period	EMV	20-Year Period	EMV	20-Year Period	EMV
Worst	739,407	Worst	261,382	Worst	1,275,914

If one examines graphically all the rolling periods of our 100 % equities credit shelter trust with no payout and an income rule trust with the eighty-four percent fixed income, one can see that the income rule trust matched the reinvesting all equity trust only starting in 1929, and normally fell short by a large multiple.



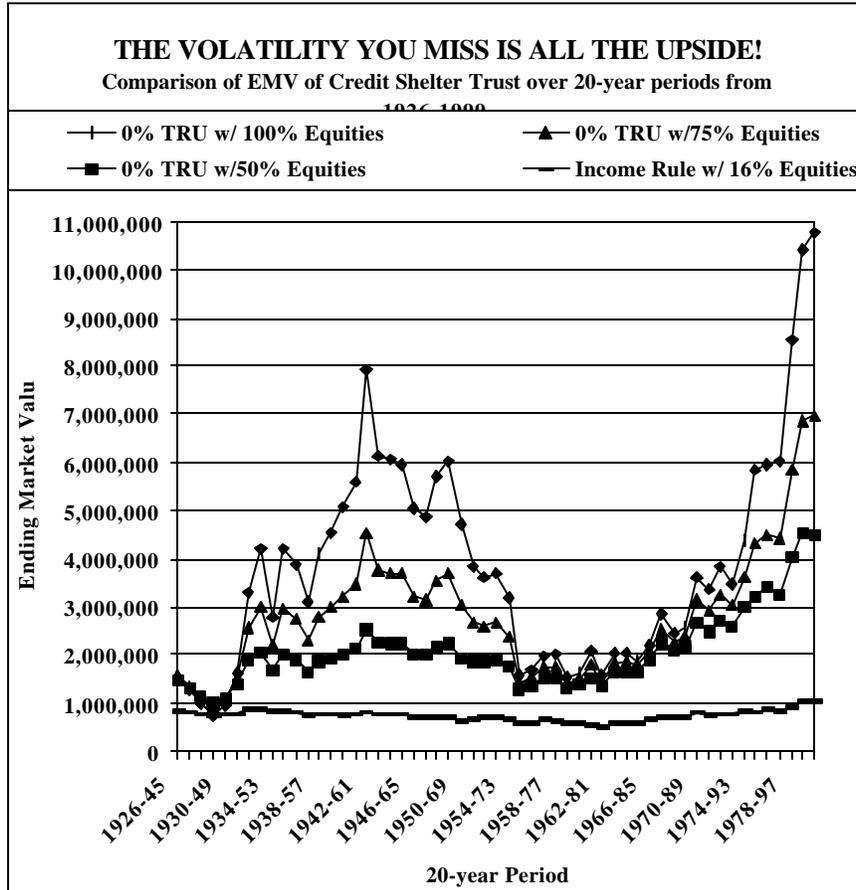
Clearly, the all equity portfolio has a great deal of volatility of results, despite the fact that it was always a better plan than the income rule trust. Planners could control the volatility by simply adjusting the asset allocation without changing the terms of the trust. The following two graphs show the results for a seventy-five percent equity and fifty/fifty trust for comparison:





By focusing on the economic benefit of total return trusts, planners can obtain better results, regardless of our risk tolerance. The fact that we are using such trusts does not eliminate the need for the trustee to assess the risk tolerance of the trust, the need for liquidity, and the risk tolerance of the family.

Total return trusts allow the trustee to invest aggressively, but also allow the trustee to invest conservatively, while focusing and managing the return more accurately. Over long periods of time, such as the twenty-year periods illustrated below, one is tempted to conclude that almost all of the volatility one avoids with the more conservative portfolio is the *upside* of volatility.



This three trust GST plan will, like the typical marital and credit shelter trust plan, be significantly impacted by EGTRRA. Form 7 in Appendix 2 to this article addresses the drafting refinements suggested, with an ordered unitrust, so that the overall rate of payout from the three trusts can be prescribed, taking into account the greater uncertainty produced as to the relative sizes of the three trusts involved. While the exempt marital trust must distribute at least the income, this ordered approach will almost certainly produce even better leverage to our tax results than the ones

illustrated above, since it pays the maximum amount possible from the least tax valuable trust first, followed by the next most valuable, and only after the exhaustion of the marital trusts will the credit shelter TRU begin its distributions. It brings better certainty to the plan, because the surviving spouse can be assured of the overall payout rate selected during the planning process.

#### G. What to Do with Existing Trusts

All of the foregoing is helpful in estate planning for the future, but what should be done with existing trusts and estate plans that have matured through the death of the settlor or testator?

##### *1. Creating Virtual Unitrusts*

How does one utilize our new tools with trusts constructed before these changes toward more modern trust design? This Article suggests an approach similar to that utilized by the drafters of section 104 of the new UPAIA.<sup>102</sup> First, one should look to the powers contained in the trust itself. To the extent the trust contains discretionary powers of distribution, even subject to ascertainable standards, these powers can be utilized to invest for total return as a prudent investor and still follow the terms of the document. For example, assume a trust requires the trustee to hold the principal and pay the income to the current beneficiary but allows the trustee to distribute additional principal for the beneficiary's "health, maintenance, and support in his or her accustomed manner of living." In response to a relatively high need for support on the part of the trust beneficiary, the trustee may have invested the fund fifty percent in stock and fifty percent in bonds, which today would yield a little under a three percent current return. If the trustee and the beneficiaries can accept the additional volatility of a higher equity mix, they could adopt, for example, an eighty percent equity and twenty percent fixed-income allocation. This would produce, of course, far less income, approximately 1.7% currently. Assume that the real need in

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<sup>102</sup> UNIF. PRINCIPAL AND INCOME ACT § 104, 7B U.L.A. 141 (2000) (describing the power to adjust income and principal).

dollars is for a return that is approximately four percent of the market value. Can the trustee prudently distribute the amount needed? The trustee should be able to achieve this objective. First, if the trustee feels a duty to impartially administer the trust and to try to retain the current value for the remaindermen after inflation, an eighty percent equity, twenty percent fixed-income mix may allow a four percent payout, at least based on long-term periods such as 1926 through 1994, even without the most recent four-year bull market in the mix, provided that the trustee does not charge too much or cause excessive turnover. However, this is not a unitrust. It is a conventional trust, and the need determinations must be expressed in dollar terms, not as a percentage. One cannot truly form a unitrust in this situation, and a smoothing rule cannot be employed. The trustee can respond to the need in a way which takes into account total return investing, modern portfolio theory, and long-term risk and return objectives.

Another situation may involve withdrawal rights, which can be used for this purpose. The case of Deceased Donald demonstrates this concept. Deceased Donald had a number of family trusts, but left a marital trust for his widow in the amount of \$2,000,000 and other tax-free generation skipping trusts of \$3,000,000:

<u>Deceased Donald</u>	
Marital Trust	\$2,000,000
GST Trusts	\$3,000,000

Donald and his family accumulated their wealth by holding on to equities over their lifetimes and passing them on through generations, without touching the underlying investments. The problem is that three quarters of their entire portfolio was represented in high-yielding oil stocks. This, of course, imposes an important diversification issue, but Donald's death presents an opportunity to diversify because of the step-up in cost basis of the assets that were taxable in his estate. Assume that the marital trust involved was an old style marital trust, which gave the surviving spouse the right to withdraw principal at any time. What might one be able to do to both diversify Donald's family's investments and to continue to provide amply for their needs?

First, because the assets passing through his estate received a new step-up in basis under section 1014, any of those assets could be sold without significant capital gains difficulties. However, how does one replace the yield of the oil stocks if the portfolios are diversified? The answer is fairly simple: implement the diversification by selling the oil stocks, which have a stepped-up cost basis; invest the proceeds of the sale of the oil stocks into a highly diversified portfolio designed to match the family's risk and return profile; and withdraw on an annual basis from the marital trust the amount which responds to the surviving spouse's cash flow needs. The decline in accounting income from the loss of the oil stock dividends can be easily made up for by a modest amount of "stock pruning," as discussed in the author's prior articles.<sup>103</sup> By using her new cost basis and lower capital gains tax rates, Donald's surviving spouse receives a higher after-tax income than would be available and a much safer investment portfolio. Once again, the trustee can respond to a need for income by looking for flexibility in the powers of the trust itself.

## 2. *The Need for Statutory Reform: A Unitrust Conversion Statute*

Many trusts lack the flexibilities of the ones described above, and for those trusts the only relief available is through the passage of the UPAIA with section 104 or through the passage of a statute which would allow conversion of an income rule trust into a unitrust. Appendix 1 of this Article contains the portions of the current Pennsylvania Bill that deal with the unitrust option followed by a series of questions and answers addressing the reasons for the choices that have been made in that Bill and which have been discussed previously in this Article. Such a statute should be considered, particularly, where section 104 is not available, and preferably in addition to section 104. The statutory solutions adopted by New York, Missouri, Delaware, and New Jersey, plus the template proposed in Pennsylvania should give state legislatures sufficient alternatives to allow them to address the issue promptly, particularly in light of the incentives provided by the Proposed Regulations.

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<sup>103</sup> See Wolf, *supra* note 2, at 85-88; Wolf, *supra* note 4, at 137-39.

Reformation or modification of income only trusts to unitrusts has been allowed under the supervision and with the cooperation of courts across the country. The legal basis for such a modification or reformation may be a frustration of purpose of the trust, or may be some other statute that gives the court the power to make a special allowance from principal.<sup>104</sup> Increasingly, more and more trusts have been modified into unitrusts at the request of beneficiaries or as a result of litigation between the beneficiaries and the trustees because of the conflicts engendered by the old style income rule trusts. But only state law change can produce the helpful certainty that is desired, particularly in the context of the Proposed Regulations.

### 3. *GST Cautionary Notes*

If the trust involved is grandfathered for GST purposes, conversion to a unitrust by court reformation may draw into question whether such a modification, because it affects the value and timing of the distribution to the beneficiary, would be construed as causing the trust to lose its grandfathered status. Final GST regulations, released in December, 2000, have clarified significantly these trust modification issues.<sup>105</sup> Such a modification, according to the regulations, would not deny the trust its grandfathered status provided two requirements are met:

- (a) No extension in vesting of generation-skipping interests is present, and,
- (b) No shifting of benefit to a lower generation occurred.

Conversion into a unitrust does not extend the vesting of GST interests. The second requirement should not be a problem because the conversion

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<sup>104</sup> A possible basis in Pennsylvania, for example, is section 6102(a) of the Probate, Estates and Fiduciaries Code which provides for “[a]n allowance from principal to one or more beneficiaries” if the original purpose of the trust cannot otherwise be carried out and such allowance “more nearly approximates the intention of the conveyer.” 20 PA. CONS. STAT. ANN. § 6102(a) (West 1975 (amended 1980)).

<sup>105</sup> See Treas. Reg. § 26.2601-1 (2000).

into a total return unitrust almost always will raise the amount of money going to the current beneficiary. For example, an income rule trust earning two percent for the income beneficiary is converted into a four percent total return unitrust, the income beneficiary is not transferring an economic interest to the remaindermen. The income beneficiary will be getting twice as much with the court reformed TRU. Despite the obviousness that such a transfer is not shifting an economic benefit to the remaindermen, a look at the valuation tables used by the Service interjects some doubt to this seemingly evident result. For example, an individual with a life estate at age seventy-five has an income interest supposedly worth 38.49% of the whole at a 5.0% section 7520 rate. A four percent TRU has a value of only 33.07% and a two percent TRU, the closest thing to what today's income beneficiary actually might receive, is worth only 18.70%. Arguably, changing an income rule trust earning two percent to a four percent TRU decreases the value of the income beneficiary's interest from thirty-eight percent to thirty-three percent; hence, the Service could argue that the reformation transferred benefit to the remaindermen, even though it did not. The real problem is that the Service tables assume that the section 7520 rate (5.0% for November, 2001) is the rate the income beneficiary receives. That is far from the truth and demonstrates that the Service's life estate tables grossly over value the life interest. The unitrust tables work fine, but they are undervalued compared with the life estate.

One approach would be to reform the trust to allow a distribution defined as the greater of the income or the TRU distribution. This approach ensures the current beneficiary's interest never could be less so that no transfer of a benefit downstream could exist. A transfer of beneficial interest from the remaindermen to the life beneficiary is not likely, because their actuarial interest using the Service's tables would be unchanged. And this approach was blessed specifically by example 8 in the final regulations.<sup>106</sup> Such is the situation if the conversion is in a state that does not have a statutory unitrust conversion statute, which would aid the process on a number of different levels. When such a unitrust conversion statute exists, the change to a unitrust method is specifically allowed by the Proposed Regulations,<sup>107</sup> both for GST purposes and for

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<sup>106</sup> See Treas. Reg. 26.2601-1(b)(2) (2000).

<sup>107</sup> See Prop. Reg. § 26.2601-1(b)(4)(i)(D)(2), 66 Fed. Reg. at 10402.

marital deduction purposes,<sup>108</sup> giving estate planners, trustees and beneficiaries a significant advantage in those states.

**V. VARIATIONS ON A THEME—  
UNITRUST VARIATIONS—JERRY HORN’S  
“GIVE-ME-FIVE” UNITRUST**

Jerold Horn has made several excellent suggestions for planners wishing to vary the unitrust theme in his article on the Prudent Investor Rule.<sup>109</sup> In his treatment of the subject, Horn suggested two variations to a private unitrust model:

- (1) A “Give-Me-Five” unitrust, and
- (2) A fractional or percentage distribution as opposed to a pecuniary payment.

Using a fractional or percentage distribution unitrust model avoids the necessary recognition of capital gains if the beneficiary does not wish the trustee to liquidate any securities required to be distributed in the pruning process, but wishes, instead, to receive the asset in kind. Although the author generally has not used this language on the theory that the trust is distributing a percentage the beneficiary actually needs and, therefore, would want in cash, this would give additional flexibility following traditional notions of the effect of distributions on a pecuniary and fractional basis. The Proposed Regulations appear to have eliminated this opportunity. They treat the distribution in kind of property as part of the trust’s required distribution of all the income currently under the revised section 643 regulations as a sale in satisfaction of the trust’s obligation to distribute

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<sup>108</sup> See Prop. Reg. § 20.2056(b)-5(f)(1), 66 Fed. Reg. at 10401.

<sup>109</sup> See HORN, *supra* note 4.

income currently. Ironically, if the trust were in a state that did not have a statutory unitrust option, one might still be in a position to argue that this was a non-recognition event, because in those states the unitrust amount would not be “income” as defined in section 643(b).

More helpful is the logical adaptation of the “five-and-five” power by giving the beneficiary what Horn calls the “Give-Me-Five” unitrust model. In this model, the beneficiary receives nothing automatically, and has the right, but not the obligation, to withdraw up to five percent of the value of the trust. By virtue of Internal Revenue Code Section 2041(b)(2), the lapse of that power, if unexercised, would not be a taxable transfer. This trust is a valuable addition to our tool chest and could be used with a smaller percentage than five percent if that were desirable. The trust puts the freedom to choose on the beneficiary and, therefore, does not provide a “method” that the testator mandated. But that is not necessarily a bad thing, depending on where the settlor wishes to be on the continuum in-between safety and certainty on the one hand and freedom and flexibility on the other. For those drafters who already use a five-and-five power in connection with their trust planning, the income and gift tax consequences of such a withdrawable power are no stranger, but they should be evaluated before selecting this Give-Me-Five unitrust model.<sup>110</sup>

Horn’s suggestion, however, should not be confused with simply adding a five-and-five power to an income rule trust. The five-and-five power creates additional flexibility, but it leaves the trustee with the same conflict in choosing investments, which determines investment “income.” Furthermore, five percent *plus* the income is generally too much to distribute if one wishes to preserve the real value of the trust. The Give-Me-Five unitrust is a helpful addition to the planner’s tool chest; the five-and-five power in addition to income is more problematic.

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<sup>110</sup> See Horn, *supra* note 4, at 46-53 (discussing the considerable tax complexities). In short, the Service has suggested that the five percent of the trust included in the power holder’s taxable income might be cumulative each year, and the payment of that mandated tax may be a gift back to the trust. See *id.* at 52. See also Cushing, *supra* note 61, at B-19-GLC-B-20-GLC.

## VI. THE GARLAND AND HERTOG-LEVINE STUDIES—TRU BUSTERS

Jim Garland and David Levine have been outspoken critics of the total return unitrust since the articles by this author and by Hoisington and Horn have brought the matter to the attention of estate planners. Indeed, Joel Dobris, in his articles about spending rules and modern trust design, discussed private unitrusts even earlier, but he seems to have turned away from them and other inventive creations in favor of section 104 of the UPAIA, of which he was a co-reporter.<sup>111</sup> The charitable remainder unitrust goes back to the 1969 Tax Reform Act and to even earlier articles suggesting the concept.<sup>112</sup> However, the dominance of total return investing today together with the historic decline in dividend yields makes unitrusts far more important. Today this planning can be combined with the ability to use computers to analyze different distribution methodologies making their advantages both striking and demonstrable. Before discussing Garland and Levine's current views on unitrusts, reviewing their past work and academic contribution to the area is helpful.

### A. Garland Rejects Income Rule Trusts

Several important studies have addressed returns after taxes, costs, and inflation. The first of these was an article by James P. Garland.<sup>113</sup> In his article, Garland examined various rules for determining how much to spend from endowments and trusts, including "market value rules," which direct a distribution based upon the market value of the portfolio, and the "spend all the income" default rule. Garland rejected the spend all the income rule because the rule "totally dominates the asset allocation policy."<sup>114</sup> Such

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<sup>111</sup> See UNIF. PRINCIPAL AND INCOME ACT, 7B U.L.A. 131 (2000).

<sup>112</sup> See Louis A. Del Cotto & Kenneth F. Joyce, *Taxation of the Trust Annuity: The Unitrust Under the Constitution and the Internal Revenue Code*, 23 TAXL. REV. 257 (1968); Robert M. Lovell, *The Unitrust: A New Concept to Meet an Old Problem*, 105 TR. & EST. 215 (1966).

<sup>113</sup> James P. Garland, *A Market-Yield Spending Rule for Endowments and Trusts*, FIN. ANALYSTS J., July-Aug. 1989, at 50.

<sup>114</sup> *Id.* at 52.

policies tend to produce the popular sixty percent equity and forty percent fixed-income mix, which provides a reasonable flow of accounting income and some potential for growth. The difficulty, as Garland pointed out, is that during times of significant inflation, the stock portion of the portfolio cannot appreciate fast enough to balance the bond component, which does not help to offset inflation. Consequently, Garland concluded that the spend all the income rule “cannot tolerate even modestly high inflation.”<sup>115</sup>

#### B. Garland’s Rule Suggests 100 percent of the Standard & Poor’s 500 Dividend Yield as the Best Standard for Spending from a Trust

Garland criticized the use of market value spending rules because of the potential for distribution volatility.<sup>116</sup> In his quest for what he believed to be an ideal spending rule, Garland focused on the dividends of the S&P 500 companies as a potential income stream to which one could peg the distributions from a foundation or trust.<sup>117</sup> For a non-taxpaying foundation, he established a spending rule of 125 percent of the yield of the S&P 500.<sup>118</sup> For taxable accounts, he concluded that spending 100 percent of the S&P 500 yield times the market value would be an appropriate spending policy that would be smooth, stable, and, for most periods, keep pace with inflation.<sup>119</sup> Garland also pointed out that investment expenses, such as trustees “or managers” fees, should be subtracted from the distribution.<sup>120</sup> Furthermore, he suggested that the bond yield begin with the S&P 500 dividend rate, not the interest received, and be reduced by the amount that stock total returns typically exceed bond returns.<sup>121</sup>

#### C. The Garland Rule Is Conservative, but Unhelpful in Present Markets

Adopting a Garland-type approach to distributions from trusts would

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<sup>115</sup> *Id.* at 53.

<sup>116</sup> *See id.* at 59.

<sup>117</sup> *See id.* at 58.

<sup>118</sup> *See id.* at 56, 58-59.

<sup>119</sup> *See id.* at 57.

<sup>120</sup> *See id.* at 56-57.

<sup>121</sup> *See id.* at 57.

produce a smooth, stable stream of income. Unfortunately, under today's market conditions, that stream would become, at best, a trickle. With the S&P 500 currently yielding 1.5%, the trustee's fee would in many cases eliminate the distributions altogether. Adding bonds actually would reduce the ability to produce a stream of income because total return from bonds is typically less than from stocks.<sup>122</sup> Nonetheless, recognition of the way dividend yields seem to track inflation and the smoothness of that income stream is important. In a charitable trust or endowment not subject to tax, Garland recommended spending twenty-five percent more than the accounting income by liquidating a portion of the portfolio at appropriate intervals.<sup>123</sup> Even though he did not note the considerable tax advantages of that method for a taxable portfolio, the methodology is identical to the stock pruning described in the author's prior articles which proves to be so helpful in preserving and building value.<sup>124</sup>

#### D. Hertog and Levine Conclude five percent Spending Is Too High

Roger Hertog and David A. Levine of Sanford C. Bernstein & Co., Inc. also authored an important study on investment returns and spending.<sup>125</sup> Acknowledging that the most powerful determinant of investment return over time is asset allocation, they demonstrated that taxes, inflation, and the need to spend some accumulated money are critical obstacles to building personal wealth. In their detailed study, Hertog and Levine excluded the 1950s, which began with common stocks yielding more than eight percent and intermediate treasuries yielding 1.3%. By the end of the 1950s, that relationship had reversed itself with dividend yields less than 3.5% and bond yields at 4.5% to five percent.<sup>126</sup> The authors examined a hypothetical investor with \$1 million to invest, spending five percent annually from 1960 to 1994 with a portfolio with sixty percent in equities mimicking the S&P 500 and forty percent fixed income in municipal bonds. Although their hypothetical investor's spending policy appears sensible, it is

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<sup>122</sup> See *id.*

<sup>123</sup> See *id.*

<sup>124</sup> See Wolf, *supra* note 2, at 85-88; Wolf, *supra* note 4, at 138-39.

<sup>125</sup> See Roger Hertog & David Levine, *Income Versus Wealth: Making the Tradeoff*, 5 J. OF INVESTING 5 (Spring 1996).

<sup>126</sup> See *id.*, at 16 n.2.

really too high because of the effects of taxes, inflation, and a sixty percent equity, forty percent fixed-income investment mix. The investor spent five percent and invested conservatively, but taxes and inflation reduced the real value of the investor's estate by fifty percent. A five percent spending policy after taxes and expenses would be the equivalent of about a seven percent unitrust distribution. Not surprisingly, the investor was unable to keep up with inflation.

Hertog and Levine then compared a three percent of assets spending rule with an income rule and a modified Garland rule calling for the distribution of bond income less the prior year's inflation.<sup>127</sup> Though the authors concluded that the three percent of assets rule was not calamitous,<sup>128</sup> they believed that a modified Garland rule was the best of the three for most investment mixes, except the twenty percent stock and eighty percent bond investment mix, which produced an extremely volatile distribution. Unfortunately, in setting their comparative budgets, Hertog and Levine allowed the portfolios using an income rule and a modified Garland rule to pay out considerably less income at the beginning, which impairs the fairness of the comparisons.<sup>129</sup> Although asset-based distribution formulas, like unitrusts, are somewhat self-adjusting during good and bad years, a higher rate of distribution produces greater volatility of distribution and a smaller total return over long periods of time. These correlations result from a loss in the compounding effect of an initial lower payout.

#### E. Hertog, Levine, and Garland Do Not Tell Us What to Do in a Climate of Vanishing Dividends

The difficulty with using the Garland rule or a similar rule based on the S&P 500 yield is that the yield has declined to a point that no longer

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<sup>127</sup> See *id.* at 12.

<sup>128</sup> See *id.*

<sup>129</sup> In the all-equities comparison, the authors compared the results of a three percent spending rule to those of an income rule and a modified Garland rule, both of which had an initial payout of 2.2%. Three percent is thirty-six percent higher than 2.2%. In their analysis of the sixty/forty balanced approach, a three percent unitrust payout began twenty percent higher than the income spending rule and fifty percent higher than the modified Garland rule. See *id.* at 13.

represents a sensible proportion of the total return or even company earnings. Undoubtedly, if beneficiaries could consume only the S&P 500 dividend yield of 1.5% less the trustees' fees, then that minuscule return would be very smooth and stable. This is little consolation to a disappointed trust beneficiary. Nevertheless, the Hertog and Levine study is important because it reinforces the importance of taxes, expenses, and spending on return. Furthermore, their data, though described and derived somewhat differently,<sup>130</sup> appears consistent with data presented in this and the author's prior articles.

#### F. Recent Updates to Garland and Levine Views—The TRU Busters!

##### 1. *An Update of Jim Garland's Views*

The author has had the pleasure of corresponding with Garland over the past several years since the author's articles first appeared. Garland continues to disfavor unitrusts and finds them as un-useful as the author finds them useful. Note, however, a number of points on which Garland and the author agree:

i. The income rule trust does not work and causes over-investment in bonds to the detriment of the financial health of long-term trusts.

ii. Over the long term, stocks are likely to allow the trust to spend more than bonds while retaining sufficient growth to maintain its real value in nominal and distribution-producing capability. In a recent article, Garland

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<sup>130</sup> Hertog and Levine used actual income and capital gains tax rates. Those rates are historically more correct, but less predictive of the future. The authors also assumed that the taxpayer had other taxable income exactly equal to the taxpayer's deductions. Furthermore, the authors approached the equation from the spending, rather than the distribution, point of view. Because of insufficient detail in their article, it cannot be determined whether the assumptions concerning the calculation of capital gains taxes or portfolio turnover are equivalent to those used in this Article. *See id.*

outlines his continuing concerns about unitrusts.<sup>131</sup> His article chronicles the movement in favor of unitrusts and equates it to the period in the late 1960s when the concept of the unitrust was born.<sup>132</sup> He specifically discusses the Ford Foundation, which financed several significant studies that popularized the idea of total return investing and allowed trustees to invest more heavily in equities.<sup>133</sup> The Ford Foundation, following its own advice, invested more heavily in equities and then found itself in a dilemma as a result of the bear market of the 1970s.<sup>134</sup> Indeed, as Garland points out, the real bear market of the 1970s started in 1966 when the S&P 500 index actually hit its high point in inflation-adjusted dollars.<sup>135</sup> It was not to regain that level after inflation until 1981.<sup>136</sup> In effect, 1966-1981 was a fifteen-year bear market. Garland thinks today's consideration of total return unitrusts reflects the same type of fad:

A natural but unfortunate result of a long bull market is a commonly shared belief that such a market will never end. Just as the bull market of the 1950s and 1960s spawned an interest in total return spending, so has the bull market of 1980s and 1990s spawned this interest in unitrusts.<sup>137</sup>

The high returns from equities spawn interest in any methodology that will allow trustee to invest for a higher total return, but the author has never taken the position that the bull market would last forever.<sup>138</sup> This is why the author has given such close examination to the results of using a unitrust starting in 1973 that illustrates the effects of a severe bear market.

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<sup>131</sup> See generally James P. Garland, *The Problems With Unitrusts*, J. OF PRIVATE PORTFOLIO MGMT. (Spring 1999).

<sup>132</sup> See, e.g., *id.* at 35.

<sup>133</sup> See *id.*

<sup>134</sup> See *id.*

<sup>135</sup> See *id.* at 41n.5.

<sup>136</sup> See *id.* at 38 (examining total returns from 1966 through 1981).

<sup>137</sup> *Id.* at 36.

<sup>138</sup> Indeed one can argue that it already has ended, but that will not quell the desire of trustees to invest impartially for total return. Whether that return may be found in stocks, bonds, or real estate investment trusts, the TRU and other total return trusts can survive, and within the limits of the investment returns available, they will thrive.

Notably, the author does not espouse a conversion of a conservative portfolio to a 100 percent equity portfolio, particularly when the portfolio cannot withstand the volatility. Apparently, this is what the Ford Foundation experienced, demonstrating the whipsaw of bad timing. Indeed, it took the Ford Foundation, which is nonetheless pretty healthy with current assets of \$14.5 billion according to its 2000 annual report, until the year 2000 to recover all of its value held in 1972 in real terms.<sup>139</sup> If one changes the asset allocation to all equity when the market is very high and then sells out or becomes more conservative when the market is low, that really will cause a problem. However, the problem is not with the unitrust: the unitrust only frees trustees to make these decisions. It does not tell them to disregard risk and think only of return. And the Ford Foundation still uses a remarkably familiar distribution rule taking into account the excise tax on private foundations and “. . . an internally derived formula equal to 5.8 percent of the average value of the investment portfolio over the previous 36 month period.”<sup>140</sup> Apparently the trustees do not find even now that a unitrust payout is undesirable!

Garland makes several additional points in his article that should be noted:

(a) A three-year smoothing rule is supposed to protect against bear markets.<sup>141</sup>

The author makes no representation that a three-year smoothing rule protects against bear markets. On the contrary, a true bear market is a market that is long enough that, even with the three-year smoothing rule, the distributions will decrease. Indeed, the TRU protects the trust by decreasing the distributions during the bear market if it lasts longer than a year. This decrease by design is important because it protects the trust from permanent depletion. We have seen ample evidence of what happens when we do not do this.

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<sup>139</sup> See historical data from 2000 annual report available at the Ford Foundation website at <http://www.fordfound.org>.

<sup>140</sup> *Id.* See “Budget and Investment Policy” under “See the Financials” at the Home Page.

<sup>141</sup> See Garland, *supra* note 113, at 39.

(b) For taxable investors no “excess” capital gain exists.

Garland concludes that, although some excess capital gain exists, it is very little:

In practice, however, charges to trust capital trustees’ fees, investment managers’ fees, and especially capital gains taxes tend to consume most if not all of this “excess” capital gain. Our own simulations suggest that the excess capital gain for typical taxable all-equity trusts during the past fifty years essentially has been zero. We suspect that it will be close to zero in the future.

This author respectfully disagrees. An eighty percent equity/twenty percent fixed-income rule trust distributing only dividends and interest from 1926 through 2000 with one percent trustees’ fees, current capital gains rates, and an index-like turnover beginning with \$100,000 would be worth \$2,122,368 at the end of 2000, or \$224,898 in inflation adjusted terms. For an all equity trust, the results are considerably better: \$4,231,915 at the end of the year 2000, or \$448,437 in inflation adjusted terms. But as we have said many times and many ways, asset allocation is indeed the key to long term returns. With an income rule trust and a typical sixty percent equity/forty percent fixed income portfolio, there is indeed no excess return from 1926 through 2000. The trust would have exactly preserved the real value. And this task of preserving real value in a trust has become considerably more difficult in modern times. A sixty percent equity/forty percent fixed income trust from 1960 to 2000 would have lost over twenty percent of its value while paying out the accounting income. This is indeed what led us to this inquiry five years ago. However, as discussed in the author’s previous articles,<sup>142</sup> the author does not disagree with Garland’s point that taxes, expenses, and excessive bond holdings make preserving the real value of the trust very difficult.

(c) Unitrusts are Bets on Market Values.

Garland points out that unitrusts base their spending on market values,

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<sup>142</sup> See Wolf, *supra* note 4, at 154-57, 162-64.

which are both unpredictable and uncontrollable, while income in the trust is something the trustee can to some degree control.<sup>143</sup> The author respectfully disagrees because the inability of the trustees to deal with the income problem today is the whole purpose behind this inquiry. Trustees certainly cannot control declines in dividend yields, nor can they control interest rates. They are trapped within the trust vehicle in which they must operate. Trustees obtain help from section 104 if their state adopts that portion of the UPAIA, but their “freedom” in the absence of such change is illusory.

(d) Unitrusts Will Lead to Market Timing.

Garland notes that trustees of unitrusts will be concerned about investing too heavily in equities because a bad market will force a decline in distributions. He posits that the income beneficiary may be a widow who plans to live off the trust distributions and hopes to be able to pass the trust capital onto her children. If the current distribution provides “just enough income,” the trustee might be afraid to invest in equities because the widow cannot afford to take the cut.

This argument seems backwards. The greater danger in unitrusts is that the trustee will become too enthusiastic with the freedom that a unitrust provides and engage in too much risk taking, followed by excessive conservatism—quite possibly what happened to the Ford Foundation. And if the unitrust gives just enough income to the widow, what would Garland propose? Unfortunately, what he proposes is a “never enough income” trust. The better solution that he describes is still a distribution of dividends from stock and “real interest from bonds” as proposed by Hertog and Levine and discussed below.<sup>144</sup> What he proposes is that not only should the trust beneficiary be satisfied with a dividend yield of stocks, but, as to bonds, the trustees need to subtract from the current bond yield the effects of inflation and expenses prior to determining an appropriate distribution from the bond portion of a portfolio. This makes logical sense, but, if applied to today’s 5.3% long-term Treasury Bond, it would result in some

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<sup>143</sup> Garland, *supra* note 113, at 39.

<sup>144</sup> See text accompanying notes 145-149, *infra*.

simple but hard to swallow mathematics. The beneficiary would be able to enjoy 5.3% less 2.5% (the average of the 1998-2000 inflation) minus one percent (trustees' fees) minus 1.53% (the taxes on the retained bond interest 4.03% less 38% tax equals 2.5% needed to offset inflation) or a net yield of .27%. Though conservative to a fault, this would only make the situation worse for the income beneficiary and for the trustee trying to invest the trust and still produce an adequate return.

Garland's system would work well were it not for the fact that the beneficiary would starve on the distribution prescribed, and starving clients are not happy clients. A distribution that produces starving, unhappy clients is not "ideal" no matter how smooth and theoretically sound it might be.

## 2. *David Levine's Current Positions*

Again, looking at those things that we agree upon before examining those on which we do not is the better approach. Levine, like Garland, agrees that equities under any sensible spending rule will produce a steadier spending stream with higher spending than bonds for "virtually all portfolios at virtually all times."<sup>145</sup> A second point is neither of us disagree with the other's back testing calculations. We disagree about the conclusions to be reached from them. Levine's original article and his more current memoranda, which were distributed in connection with the proposed New York legislation, deal with spending rather than distributions. This is a natural distinction because he is an economist and the author is a trust and estate lawyer, but distributions is the more pertinent inquiry when discussing trusts. Distributions always will be more or even substantially more than what one can spend because of taxes.

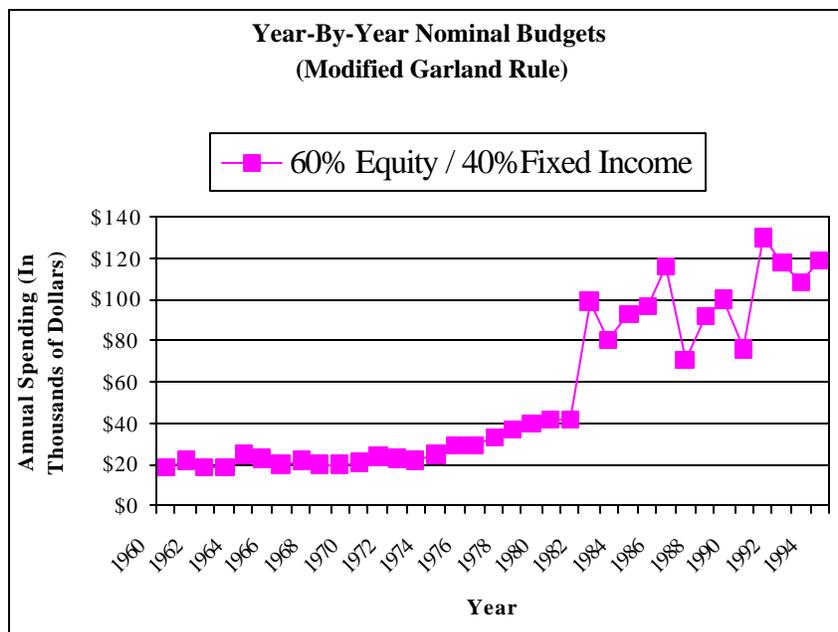
Levine urges the use of what he calls the modified Garland rule in which the bond portion of the portfolio, as described above, subtracts expenses and inflation from its yield. While theoretically sound, it would increase the difficulties for a trust beneficiary today and produce "an extremely volatile spending stream."<sup>146</sup> Indeed, Levine's own data, as

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<sup>145</sup> Memorandum of David Levine to Jerome Levine et al. concerning proposed unitrust legislation dated April 6, 1999, at 8.

<sup>146</sup> *Id.*

taken from his prior article, show the excessive volatility of the modified Garland rule even for the relatively stable sixty/forty “fiduciary portfolio.”

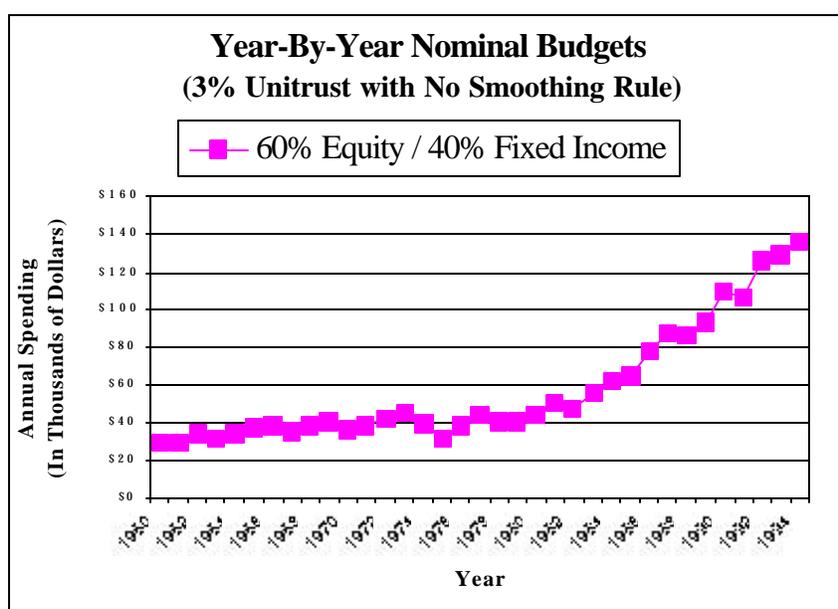


Even without the three-year smoothing rule, a unitrust for this period looks a lot smoother and more sensible. See the graph on page 262.

Probably the strongest argument that Levine makes against the use of a four percent unitrust as a default standard is simply that the rate of return on equities in the future will be dramatically lower than it has been for the past. He forcefully makes the case based on fundamental value economics.<sup>147</sup> Because of the expansion of price/earnings ratios and astronomical valuations in the stock market at that time, he projected a long term total equity return of only 5.26% before inflation. With a projection of

<sup>147</sup> *Id.* at 4-8.

the CPI at 2.4% he projects a real return of 2.8%.<sup>148</sup> If he is correct about this, obviously a trust cannot hold its real value paying out more than the 2.8% minus trustees' fees and any other taxes and costs paid by the trust. This would be a very dour prognostication, and would favor heavier investments in bonds which became timely advice a year later in 2000, but is it suitable guidance for the long term?



Possibly he is correct in that the real return from stocks will be 2.8% or less in the future. If so, the trend will be a great reversal from the returns of the past that for the past 200 years have averaged approximately seven percent.<sup>149</sup> However, that argues against using a four percent rate more than against using a unitrust. Indeed, if we have a terrible bear market, a unitrust with a lower spending rate will protect the trust much better than would any methodology that maintains the distribution at a higher level

<sup>148</sup> David Levine, Materials Distributed at Meeting of Surrogate's Court Committee, Ass'n of the Bar of the City of N.Y., May 10, 1999, at 5.

<sup>149</sup> JOHN C. BOGEL, COMMON SENSE ON MUTUAL FUNDS: NEW IMPERATIVES FOR THE INTELLIGENT INVESTOR, at 9, 13 (1999).

despite highly negative total returns. This is potentially the same scenario as the author modeled in the 1970s. Such a possibility is the reason that so much time was spent examining it.

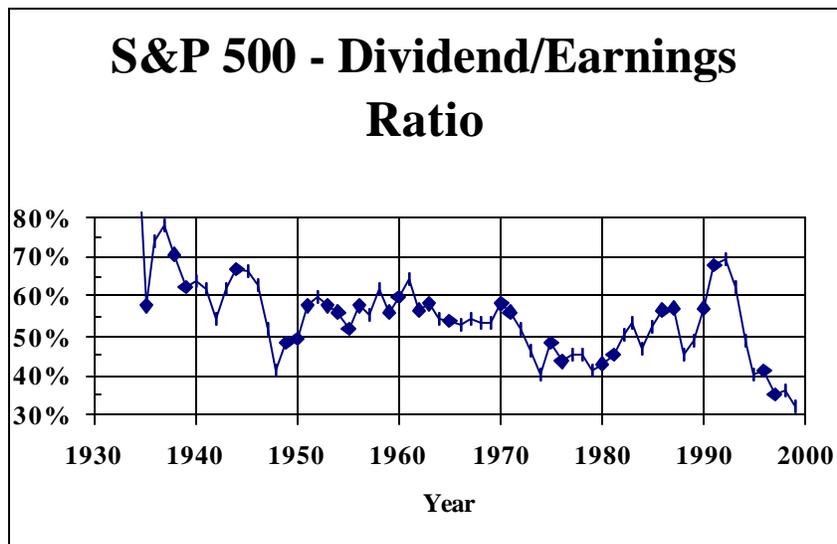
Garland and Levine place great reliance on the S&P 500 dividend rate as a polestar. With the S&P 500 current dividend yield at 1.53%, the payout ratio of dividends to corporate earnings for those companies has declined to an historic low. Despite record high earnings on the S&P 500 for 1999, dividends represented only thirty-two percent of earnings, the lowest payout ratio in the seventy years since the S&P 500 began keeping those records.<sup>150</sup> And the year 2000 was even lower, with the ratio slightly under twenty-nine percent.<sup>151</sup> Significantly, this must be a reflection of total return investing and tax consequences of corporate share buy-backs, which are more favorable to investors than simply raising dividends.<sup>152</sup> The graph below shows the S&P 500's dividend-to-earnings ratio. At the time of the original Garland article, the payout ratio of dividends to earnings was about forty-eight percent. In 1992, it rose to seventy percent, more than double the 1999 ratio.

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<sup>150</sup> See Infoseek: Newscenter Article, Business Wire (October 1, 1997); S&P 500 earnings were \$50.82 and dividends were \$16.32 for 1999—a payout of 32.11%; (data from Bruce A. Guiot, Vice President and Director, PNC Advisors Trust Company).

<sup>151</sup> Dividend data of \$16.265 from Jeffrey N. Kleintop, PNC Advisors, Operating Earnings for 2000 of \$56.13 from Standard & Poor's Website [www.spglobal.com/earnings.html](http://www.spglobal.com/earnings.html).

<sup>152</sup> See Infoseek, *supra* n. 150.



Although companies tend to increase dividends in a poor equity market to attract people to the market and support stock prices, seemingly, some secular change has occurred concerning the polestar of Garland's theory.

In summary, neither Garland nor Levine gives us a sensible alternative to a unitrust in the current environment. The unitrust provides a unity of interest between the current and remainder beneficiaries and the trustee, protects the trust in the event of a bear market such as Levine thinks is likely, and produces dollar averaging results that increase the total return when markets go up and down, as they most certainly will do.

Perhaps no perfect measure exists of an appropriate proportion of return to distribute to the life beneficiary. If one's goal is to keep a payout reflective of increases in the beneficiary's living expenses, an indexed payout trust accomplishes this goal. This undertaking will require great care, however, to avoid exhausting the funds that support the indexed payment. If the goal is to share the return between current beneficiaries and remaindermen, no rule is likely to be more effective than the total return unitrust.

#### G. Total Chaos: Misapplying Total Return Trusts

Another article highly critical of total return trusts was published in *Financial Planning Magazine* by Frank Croke.<sup>153</sup> In this article, Croke lumps all total return trusts together as total return unitrusts and asserts that they are being used as “one size fits all” form trusts, usually paying out five percent.<sup>154</sup>

If this were true, this author would heartily agree that the use of the same type of trust for everyone would be a disservice to our clients. In response, Croke advocates what he calls the “planned income trust.”<sup>155</sup> This planned income trust would increase the distribution by three percent or, if the CPI index increased by more than that, by the appropriate CPI increase. He then points out correctly that the income would be much smoother on an inflation-adjusted basis using this methodology.<sup>156</sup> The difficulty with the planned income trust is that it is a somewhat more risky<sup>157</sup> variation of the index payout trust, which requires a great deal of capital for a relatively low income need to be safe from depletion over long periods of time. As illustrated earlier, forty percent of all of the thirty year or shorter rolling periods starting from 1926 through a starting year of 1974 would result in a completely depleted trust with an indexed payout of five percent. So, while a unitrust payout is far more volatile, it is considerably safer if the payout need is to approach five percent.

Croke also notes that total return trusts have a potential for depletion in real terms when the grantor selects an annual payout of eight percent or more.<sup>158</sup> This is absolutely correct. In fact, at eight and one-half percent, there is only one twenty year period in which the real value of a trust portfolio invested eighty percent in equities and twenty percent in fixed income would have maintained its full value 1980-1999. That level of

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<sup>153</sup> Frank Croke, *Total Chaos Total Return Trusts May Create More Estate Planning Problems than They Solve. Here's Why*, FINANCIAL PLANNING, May 2000, at 95.

<sup>154</sup> *See id.*

<sup>155</sup> *See id.*

<sup>156</sup> *See id.* at 98.

<sup>157</sup> The planned income trust is more risky because it has a higher payout in low inflation times because it increases the distribution by three percent at a minimum, even if inflation is less than three percent.

<sup>158</sup> Croke, *supra* note 153, at 95.

payout may seem attractive to today's investor used to the huge returns we enjoyed through 1999, but is simply too high for long-term planning.

The concept for most laws is to provide a uniform code that will apply to all situations, but this does not apply to estate planning and should not be the controlling factor. A trust should be tailored to the individual wishes of the grantor to satisfy the family requirements. The grantor is in a better position to know what is required than either the attorney or the form trust. He needs to know that he has the authority to exercise options which will fill his requirements. To obtain the greatest benefit for a family, a trust must be tailored to the individual needs of the family.<sup>159</sup>

With the foregoing, this author unqualifiedly agrees. Total return trusts include much more than just total return unitrusts. Furthermore, the use of the unitrust and other types of trusts that allow clients to specify the payout for the first time bring clients into the trust design process. Therefore, they can both understand what might be available to their family members after their death and in a meaningful way, take a part in the estate planning process. Using the variety of total return trusts that are available now and will become available over time to planners should enhance the ability to tailor an estate plan to the specific needs of the beneficiaries while allowing the trustee to invest for total return. Such criticisms are valid against planners who simply use a form five percent unitrust without considering the needs of the client or the client's response to volatility. But this has never been the approach of this author. There is never a trust for all clients and all seasons. And those seeking to use any of these new forms of trust must be conversant with their economic, financial, and tax consequences. An indexed payout trust like the planned income trust may be an ideal vehicle for the income beneficiary, but the risks of depletion must be fully considered and revealed to the client unless some device is used for attenuating that risk such as the TRUCAP described previously.

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<sup>159</sup> *See id.* at 104.

## VII. SIMULATION ANALYSIS BY COLLINS, SAVAGE, AND STAMPFLI

In their interesting article published in this Journal last summer,<sup>160</sup> the authors apply a considerable dose of probability theory and statistics to analyze the effects of different distribution formulae using different payout rates and differing asset allocations, particularly employing a comparison of risk and return using a highly diversified portfolio against one which consists solely of large capitalization stocks and bonds. They employ a “submartingale” price change model that builds into it a deterministic component, recognizing that capital markets have a propensity to increase in value by at least the growth in their underlying economies, and a “stochastic” component reflecting the randomness of stock movements.<sup>161</sup> The model takes into account the fact that inflation is “sticky” and does not change randomly from year to year, and the historical autocorrelation between individual asset classes and differing inflation environments. This author lacks the mathematical credentials to examine credibly the exact methodology used, and Collins, Savage, and Stampfli do not reveal the exact methodology used.

Much of the purport of the article concerns the fact that there are significant risks inherent in attaining the goals of preserving value and income stream from the point of view of the current beneficiary and the remainderman even using total return trusts. With this conclusion the author heartily agrees. Indeed, the risk of failure set forth in the Article is likely to be considerably understated because of some of the assumptions utilized in that study. Specifically, “[t]axes, investment expenses and other portfolio frictions are ignored.”<sup>162</sup> These factors are extremely important in real world trusts.

In the author’s second article, a five percent unitrust was modeled from

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<sup>160</sup> See Patrick J. Collins, Sam L. Savage, & Josh Stampfli, *Financial Consequences of Distribution Elections From Total Return Trusts*, 35 REALPROP. PROB. & TR. J. 243 (2000).

<sup>161</sup> *Id.* at 289-90.

<sup>162</sup> *Id.* at 246.

1926 through 1996 with an all equity portfolio. Without these frictional costs, the portfolio ended the period at \$5.2 million. Taking them into account, even using a low index like turnover of five percent and today's lower capital gains tax, the amount remaining was \$1.6 million, which is more than enough to keep up with inflation, but not by a lot.<sup>163</sup> Indeed, with a seventy-five percent equity-twenty-five percent bond portfolio, the portfolio would have declined in real terms by six percent. Without those frictional costs, the market value would have increased by over 200 percent. Hence, any analysis that does not take these factors into account must not be relied upon in planning for a trust that must contend with them.

A second question is whether the period during which price movements were studied and incorporated into the model, 1973 through 1998,<sup>164</sup> is a sufficiently rich set of data upon which to base the simulation program. That period, for example, did not contain a time in which the economy experienced a deflationary recession or depression such as was experienced in the 1930's. How can one be sure that such data are irrelevant for the future? Longer and broader data might be needed to reflect truly the statistical risk and return characteristics of portfolios. One must also wonder if the historical negative correlations of the U.S. markets with the highly developed markets overseas are reliable in light of the considerable and growing economic and informational exchange and interdependence of those markets.<sup>165</sup> One must be very careful in examining potential results, whether by historical back testing or simulation testing to adjust for the appropriate frictional costs and to reflect expected values in inflation adjusted terms.

Collins, Savage, and Stampfli favor a flexible distribution guideline rather than a formula, with the trustee relying on the grantor's statement of goals.<sup>166</sup> They also favor the ability of ongoing portfolio sufficiency testing using a simulation model such as the one they have produced. This author agrees with the utility of the discretionary trust and the importance of the

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<sup>163</sup> See Wolf, *supra* note 4, at 155.

<sup>164</sup> See Collins et al., *supra* note 160, at 301.

<sup>165</sup> See Stephen B. Wilcox and Mikko B. Huuonen, *International Diversification: Are the Benefits Dwindling?* AAI JOURNAL, May 1999, at 16.

<sup>166</sup> See Collins, *supra* note 160, at 243.

expression of the grantor's goals in the trust document.<sup>167</sup> However, this author questions the concept of ongoing sufficiency monitoring to determine the ability of the trust to support a certain set of payments to the current beneficiaries. If, for example, the portfolio was to decline by fifty percent, the monitoring function, without an element of forecasting, would indicate that to preserve the same probability of goal attainment, such as preserving the real value of the portfolio, the distribution would have to also go down by fifty percent. With the mitigation afforded by the three year smoothing rule, this is what a unitrust does when the market goes down. The three year smoothing rule is a beneficiary sensitive provision rather than an economics or market driven rule. A unitrust without the smoothing rule actually will do better in a poor market because the distribution will adjust downward more quickly, but it is not as beneficiary friendly. We must not lose sight of the fact that trusts must be designed to fulfill the real needs of people, not the goals of economists, mathematicians, or even estate planners!

The Collins, Savage, and Stampfli article is a valuable addition to the literature in this field because it emphasizes the probabilistic nature of returns and attempts to describe those risks in a highly sophisticated manner.

### VIII. FREQUENTLY ASKED QUESTIONS AND ANSWERS

#### A. Is a Fully Discretionary Trust Preferable to a TRU Because of its Flexibility?

This is a question which Susan Porter of U.S. Trust raises in response to unitrusts.<sup>168</sup> This point was also made in the course of an exchange in the North Carolina Bar Association publications in response to a pro-unitrust article by Mark B. Edwards.<sup>169</sup> The usefulness of the fully

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<sup>167</sup> *See id.*

<sup>168</sup> *See* Susan Porter, *The Total Return Trust and Prudent Investing-Is it Desirable*, 13-14, A.B.A. Section of Real Prop., Prob. & Tr. L. Spring 1999 CLE Meeting (May 1999).

<sup>169</sup> Edwards, *supra* note 4, at 1; Holding & Reid, *supra* note 4, at 1.

discretionary trust has been pointed out earlier in this Article as well, particularly in combination with the TRU if income is truly needed and relied upon by the beneficiary. A fully discretionary trust is often superior to a TRU wherever the mandatory payout of funds from the trust may be disadvantageous. This would most often be true with respect to a credit shelter trust or a dynasty trust. Indeed, by combining the use of a total return unitrust with a discretionary trust, we can focus the economic benefits the way we wish, which is much more accurate than with an income rule trust.

The author uses fully as many if not more discretionary trusts than total return unitrusts in his practice, but no one trust is correct for all circumstances. Concluding that any one trust will work well for all of the great variety of situations estate planners are faced with would be great error. The fully discretionary trust, despite its usefulness, will be unacceptable to many people who do not have sufficient confidence in the trustee to invest all that power in the trustee. How do they know that the trustee will exercise such power in a proper way? In many situations, the use of a unitrust to address the beneficiary's income needs will help give the beneficiary the confidence to accept a fully discretionary trust elsewhere.

#### B. Does a Five-and-Five Power Accomplish the Same Thing?

If the income beneficiary has a five-and-five power in an existing income rule trust, it may be very helpful in producing a higher yield for the beneficiary. The beneficiary simply can exercise the power rather than pressure the trustee to invest more in bonds to produce greater income. However, a distribution that is based on income plus a five-and-five power still produces the same conflict about how much the income should be. This is the difference between simply adding a five-and-five power and Jerry Horn's Give-Me-Five unitrust, which is a superior model.<sup>170</sup> And the

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<sup>170</sup> Even a total return unitrust might encounter this problem if rates escalated sufficiently. If the document provides for the payment of income only if greater than the distribution amount in order to qualify for the marital deduction, again, this highlights the advantages of maintaining a trust in a state with a statutory

five-and-five power is not a system. It is a power. Fundamentally, many of these issues involve who is in charge and who makes the decision about what a trust distribution ought to be. Just as beneficiaries often are concerned about an independent trustee's discretion in a fully discretionary trust, so a settlor of a trust who sets up a trust to guard against the beneficiary's outstripping his assets and income should have concerns that the five-and-five power would only help the beneficiary do so more quickly. There can be little debate that withdrawing five percent plus the accounting income from a trust likely would deplete severely its real value over time.

C. Are TRUs a Good Choice for Trusts Containing Closely-held Business Interests, LLCs or FLPs?

Though conceptually they can hold closely-held business interests, the TRU is a response to a problem that may not exist in a family owned business where the family may well have control over the stream of distributions from the business entity. The TRU is primarily designed to respond to the need for trustees to invest for total return in the financial markets and to satisfy their duties of impartiality as between the current beneficiary and the remaindermen without disappointing both. They are not designed with this type of asset in mind and other types of trusts should be considered.

## IX. MODERN TRUST DESIGN ONLY THE BEGINNING

The development and implementation of the trusts described in this Article (the total return unitrust, the indexed payout trust, the no-drop unitrust, the TRUCAP index trust, the "Give-Me-Five" unitrust, the ordered unitrust (as illustrated in the attached forms and in response to EGTRRA) and the fully discretionary trust) are by no means exhaustive of the trust possibilities.<sup>171</sup> The author previously has discussed the use of a number of

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unitrust.

<sup>171</sup> For example, a TRU Collar with a cap and a floor to an indexed payout would be conceptually sound, and a wide variety of other types could be developed once the ingenuity of our estate planning professionals is focused more

other new methods for defining trust distributions that would allocate the risks of future investments between the current beneficiary and the remaindermen differently. Estate planners should continue to explore additional types of trusts that are designed to satisfy the human needs of the beneficiaries while not impeding the investment goals of the trusts. Variations and limitations on the distribution rules provided by the indexed payout trust or the unitrust might be used fruitfully in some situations and match with precision the settlor's concerns about the future. After being stuck in a rut for literally hundreds of years in writing trusts that direct the trustee to hold the principal and pay the income, we have no reason to expect that the ingenuity of lawyers in crafting new trust vehicles will stop now that we have broken out of our income cocoon. Estate planners should instead continue to develop new and favorable designs for trustees and beneficiaries.

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on the investment goals and the human and financial needs of our trust beneficiaries. See e.g., David Diamond, *supra* note 4 (describing a 3-4-5 PRU (prudent rate unitrust) that specifies a graduated percentage unitrust paying out three percent during the beneficiary's thirties, four percent during her forties and five percent in her fifties and beyond).

**APPENDIX 1****PROPOSED PENNSYLVANIA STATUTE TO ALLOW  
PRIVATE TRUSTS  
TO CONVERT TO TOTAL RETURN TRUSTS**

§ 8105. Power to convert to unitrust (from Pa. S. Bill 1014).

(a) Conversion. – Unless expressly prohibited by the governing instrument, a trustee may release the power under section 8104 (relating to trustee's power to adjust) and convert a trust into a unitrust as described in this section if all of the following apply:

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

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

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

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

(3) There is at least one sui juris beneficiary under paragraph (2)(i) and at least one sui juris beneficiary under paragraph (2) (ii).

(4) No sui juris beneficiary objects to the conversion to a unitrust in a writing delivered to the trustee within sixty days of the mailing of the notice under paragraph (2).

(b) Judicially approved conversion. –

(1) The trustee may petition the court to approve the conversion to a unitrust if any of the following apply:

(i) A beneficiary timely objects to the conversion to a unitrust.

(ii) There are no sui juris beneficiaries under subsection (a)(2)(i).

(iii) There are no sui juris beneficiaries under subsection (a)(2)(ii).

(2) A beneficiary may request a trustee to convert to a unitrust. If the trustee does not convert, the beneficiary may petition the court to order the conversion.

(3) The court shall approve the conversion or direct the requested conversion if the court concludes that the conversion will enable the trustee to better carry out the intent of the settlor or testator and the purposes of the trust.

(c) Consideration. – In deciding whether to exercise the power conferred by subsection (a), a trustee may consider, among other things, all of the following:

(1) The size of the trust.

(2) The nature and estimated duration of the trust.

(3) The liquidity and distribution requirements of the trust.

(4) The needs for regular distributions and preservation and appreciation of capital.

(5) The expected tax consequences of the conversion.

(6) The assets held in the trust; the extent to which they consist of financial assets, interests in closely held enterprises, tangible and intangible personal property or real property; and the extent to which an asset is used by a beneficiary.

(7) To the extent reasonably known to the trustee, the needs of the beneficiaries for present and future distributions authorized or required by the governing instrument.

(8) Whether and to what extent the governing instrument gives the trustee the power to invade principal or accumulate income or prohibits the trustee from invading principal or accumulating income and the extent to which the trustee has exercised a power from time to time to invade principal or accumulate income.

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

(d) Post conversion. – After a trust is converted to a unitrust, all of the following apply:

(1) The trustee shall follow an investment policy seeking a total return for the investments held by the trust, whether the return is to be derived:

(i) from appreciation of capital;

(ii) from earnings and distributions from capital; or

(iii) from both.

(2) The trustee shall make regular distributions in accordance with the governing instrument construed in accordance with the provisions of this section.

(3) The term "income" in the governing instrument shall mean an annual distribution (the unitrust distribution) equal to four percent (the payout percentage) of the net fair market value of the trust's assets,

whether such assets would be considered income or principal under the provisions of this chapter, averaged over the lesser of:

- (i) the three preceding years; or
- (ii) the period during which the trust has been in existence.

(e) Discretion of trustee. – The trustee may in the trustee’s discretion from time to time determine all of the following:

- (1) The effective date of a conversion to a unitrust.
- (2) The provisions for prorating a unitrust distribution for a short year in which a beneficiary’s right to payments commences or ceases.
- (3) The frequency of unitrust distributions during the year.
- (4) The effect of other payments from or contributions to the trust on the trust’s valuation.
- (5) Whether to value the trust’s assets annually or more frequently
- (6) What valuation dates to use
- (7) How frequently to value non-liquid assets and whether to estimate their value.
- (8) Whether to omit from the calculations trust property occupied or possessed by a beneficiary.
- (9) Any other matters necessary for the proper functioning of the unitrust.

(f) Allocation. –

- (1) Expenses which would be deducted from income if the trust were not a unitrust may not be deducted from the unitrust distribution.

(2) Unless otherwise provided by the governing instrument, the unitrust distribution shall be paid from net income, as such term would be determined if the trust were not a unitrust. To the extent net income is insufficient, the unitrust distribution shall be paid from net realized short-term capital gains. To the extent income and net realized short-term capital gains are insufficient the unitrust distribution shall be paid from net realized long term capital gains. To the extent income and net realized short term and long term capital gains are insufficient, the unitrust distribution shall be paid from the principal of the trust.

(g) Court orders. – The trustee or, if the trustee declines to do so, a beneficiary may petition the court to:

(1) Select a payout percentage different than four percent.

(2) Provide for a distribution of net income, as would be determined if the trust were not a unitrust, in excess of the unitrust distribution if such distribution is necessary to preserve a tax benefit.

(3) Average the valuation of the trust's net assets over a period other than three years.

(4) Reconvert from a unitrust. Upon a re-conversion, the power to adjust under section 8104 shall be revived.

(h) Application. – A conversion to a unitrust does not affect a provision in the governing instrument directing or authorizing the trustee to distribute principal or authorizing a beneficiary to withdraw a portion or all of the principal.

(i) Prohibited conversions. – A trustee may not convert a trust into a unitrust in any of the following circumstances:

(1) If payment of the unitrust distribution would change the amount payable to a beneficiary as a fixed annuity or a fixed fraction of the value of the trust assets.

(2) If the unitrust distribution would be made from any amount

which is permanently set aside for charitable purposes under the governing instrument and of which a Federal estate or gift tax deduction has been taken, unless both income and principal are so set aside.

(3) If:

(i) possessing or exercising the power to convert would cause an individual to be treated as the owner of all or part of the trust for Federal income tax purposes; and

(ii) the individual would not be treated as the owner if the trustee did not possess the power to convert.

(4) If:

(i) possessing or exercising the power to convert would cause all or part of the trust assets to be subject to Federal estate or gift tax with respect to an individual; and

(ii) the assets would not be subject to Federal estate or gift tax with respect to the individual if the trustee did not possess the power to convert.

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

(6) If the trustee is a beneficiary of the trust.

(j) Permissible conversion when otherwise prohibited. –

(1) If subsection (i)(3), (4) or (6) applies to a trustee and there is more than one trustee, a co-trustee to whom the provision does not apply may convert the trust, unless the exercise of the power by the remaining trustee or trustees is prohibited by the governing instrument.

(2) If subsection (i)(3), (4) or (6) applies to all the trustees, the

trustees may petition the court to direct a conversion.

(k) Release of the power to convert. –

(1) A trustee may release the power conferred by subsection (a) to convert to a unitrust if any of the following apply:

(i) The trustee is uncertain about whether possessing or exercising the power will cause a result described in subsection (i)(3), (4) or (5).

(ii) The trustee determines that possessing or exercising the power will or may deprive the trust of a tax benefit or impose a tax burden not described in subsection (i).

(2) The release may be permanent or for a specified period, including a period measured by the life of an individual.

**[Pennsylvania Comment: Section 8105 allows conversion to a unitrust, in which case the question of how to allocate receipts and disbursements between income and principal becomes irrelevant. The 4% unitrust is an alternative to using the power to adjust under section 8104 to determine the appropriate distribution to the current beneficiary. Caveat: The federal income tax treatment of unitrusts is uncertain and converting a trust exempt from generation-skipping tax into a unitrust may result in a loss of the exemption. Subsection (g) is designed in part to allow the trustee by petition to the court to preserve this tax benefit.**

**Section 8105(a)(2). Since the unitrust may not be familiar to most beneficiaries, the trustee is required to notify them, and cannot convert to a unitrust in the face of an objection from a beneficiary without a court order.**

**Section 8105(c). This list of factors to consider is parallel to the list in the prudent investor act in 20 Pa. Cons. Stat. § 7203(c).**

**Section 8105(e). Giving the trustee discretion seems preferable to**

**creating a statutory straightjacket.**

**Section 8105(i), (j) and (k) parallel similar provisions in section 8104 regarding the power to adjust.]**

**QUESTIONS AND ANSWERS CONCERNING  
THE UNITRUST CONVERSION STATUTE**

1. Why choose a four percent payout rate?
  - a. As a default rate, four percent provides a generous current return while also providing good prospects for the preservation of real value of the trust over long periods assuming a conservative investment mix of approximately two-thirds equities and one-third bonds.
  - b. Through the period 1960 through 1998, such a unitrust would keep the distribution going throughout this long period, producing the highest rate of distribution at the end of all possible rates (depending a bit on investment mix). Higher rates over long periods depress growth.
  - c. Such a rate would provide considerable relief. In today's markets, a four percent distribution from an income rule trust would require over seventy percent to be invested in fixed income securities. A prudent investor would never invest such a high proportion of a trust in fixed income securities.
2. Why not give the trustee full discretion to select the percentage?
  - a. Trustees today have little or no experience in selecting such rates, so for most of them such a choice would be burdensome rather than attractive.

- b. The proposed statute allows a different rate to be selected, but requires court approval because changing rates, particularly at the extremes, affects the economics of the trust tremendously and the apportionment of benefits between current and remainder beneficiaries.
  - c. Because one can make a statistical case that a trust invested for total return with a reasonable asset allocation can preserve the real value of the trust with a four percent distribution, one can argue that such preservation is consistent with the original meaning of the word "income," and consistent with the true intent of the settlor.
  - d. The change from an income rule trust to, for example, a 2 percent trust or a seven percent trust by a non-independent trustee, might be considered to be a taxable transfer for gift tax purposes, because of the substantial shift in economic benefits.
3. Why not allow the trustee to select the distribution rate annually?
- a. An annual requirement to select a distribution rate would be unattractive to trustees who must then make a fundamental decision about the trust at least once a year.
  - b. The temptation would be to pay out a higher rate when interest rates are high and a lower rate when they are low. This is exactly contrary to good financial practice. High interest rates imply high inflationary expectations and typically are a companion of very low total returns, hence reflecting the very reverse of what should occur in distribution practice.
  - c. The 1970s are an ideal example of this in which the periods of high interest rates would have been the very worst and most expensive time to increase distributions. Consider the interest rates in 1981 and the implications of increasing distribution (decreasing investment) just before

the start of the bull market in 1982.

- d. A consistent unitrust distribution requires distribution of higher amounts during high markets (selling high) and distribution of lower amounts in low markets (buying low).
4. Why adopt a default rule using calendar years and a three year smoothing rule?
    - a. Three years was developed as the smallest number of years needed to significantly reduce the number and magnitude of declines in annual distributions during long periods of time. While longer periods will produce somewhat smoother distributions, the trade-off is not worth it at the cost of unlinking the fortunes of present and future beneficiaries.
    - b. The longer the smoothing rule, the smaller the dollar averaging benefit.
    - c. Adopting a calendar year valuation allows the trustee and beneficiary to know the distributions for the entire next year at the beginning of the year. This optimizes the beneficiary's ability to budget—an ability often missing from trust income. It also allows the trustee to know how much liquidity it will need throughout the course of the year.
  5. Why do we think the research data from the past will reflect the future?
    - a. We have studied the results of different distribution methods and asset allocations through three extended periods of time:  
  
1960 through 1998—a long period containing all types of markets—with a bull market, a bear market, and some in-

between. It contains a period of high inflation and very low inflation.

1973 through 1998—a worst-case scenario from the point of view of equity investing because of the 1973/1974 period (worst two- year period since the 1930s) and the rest of the bear market of the 1970s.

1926 through 1998—we have examined the effects during the entire Ibbotson period for which truly accurate and standardized data has been provided.

- b. We have studied all of the rolling twenty-year periods since 1926. A four percent unitrust payout with an eighty/twenty equity mix would have preserved the real value of the trust in fifty-eight percent of the periods, and beats a fifty/fifty income rule trust in ending market value in forty-nine out of fifty rolling twenty-five year periods.
  - c. Professor Jeremy Siegal has tracked these returns normalized for inflation back to the year 1801. His conclusion on the trend line of total return from equities is that they produce after inflation (real) returns of 6.8%. Once trustee's fees, expenses, and taxes are taken into account, this two century thesis is extremely consistent with computer modeling findings.
  - d. Unitrust theory depends on mathematics—not prognostication.
- A. What if the trustee converts to a Total Return Trust and the trustee and the beneficiaries are dissatisfied with the Total Return Trust?
  - B. The trustee can reconvert by obtaining court approval.
  - C. The mathematics of unitrust theory and historical study suggests that periods in which the current beneficiary may be dissatisfied with the payout is precisely when the trustee should “stay the

course” for the long-term economic health of the trust and its beneficiaries.

## APPENDIX 2

### TOTAL RETURN TRUST FORMS

#### THE BASIC TOTAL RETURN UNITRUST (TRU) FORM

The following TRU model is drafted based on the research and discussion set forth in the author's articles and published materials. While the TRU is a new form of trust, it is based on well-established principles of current law. This includes the trends likely to occur as the Prudent Investor Act and the new Uniform Principal and Income Act gradually influence fiduciary law.

#### THE TOTAL RETURN UNITRUST (TRU)

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

A. During\_\_\_\_\_ life. My trustee shall pay the unitrust amount set forth below to or for the benefit of my \_\_\_\_\_ during h\_\_\_\_\_ life, in quarter-annual installments.

B. Unitrust amount. The trustee shall pay to my \_\_\_\_\_ in each year of this trust ("trust year") during h\_\_\_\_\_ life a unitrust amount equal to \_\_\_\_\_ (\_\_\_\_ percent) percent of the fair market value of the trust as of the close of the first business day of the trust year (or the date of first funding for the first trust year) and the two previous trust years (or such lesser number of trust years as are available for the first two years of the trust)( "unitrust amount"). In the case of a short tax year, the unitrust amount shall be calculated as set forth in subparagraph C below. In the case of contributions to or distributions from the trust, including initial funding, the unitrust amount shall be determined as set forth in subparagraph D below. **[Non-accrual alternative: The obligation to pay the unitrust amount shall cease with the last regular payment before my \_\_\_\_\_ death.]**

C. Short year. For a short trust year, **[including the**

**year of a beneficiary's death]** the unitrust amount shall be based upon a prorated portion of the unitrust amount set forth above, comparing the number of days in the short trust year to the number of days in the calendar year of which the short trust year is a part. **[Note: This accrual may be helpful in securing "present interest" status for the annual gift tax exclusion, if that is important.]**

D. Contributions and Distributions. **[This complicated language is needed to accommodate multi-year funding of trusts from estates and discretionary distributions in light of the three-year smoothing rule.]** In a trust year in which assets are added to or distributed from the trust (other than the unitrust amount) (hereinafter "adjustment year"), the unitrust amount shall be increased (in the case of a contribution) or decreased (in the case of a distribution) by an amount equal to \_\_\_\_\_ (\_\_\_ percent) percent times the fair market value of the assets contributed or distributed (as of the date or dates of the contribution or distribution), multiplied by a fraction, the numerator of which is the number of days from the contribution or distribution to the end of the calendar year, and the denominator of which is the days in the calendar year. Further, the beginning year values for the adjustment year and the trust year immediately preceding the adjustment year (unless the adjustment year is the first year of the trust) shall be increased by the amount of such addition, or decreased by the amount of such distribution, for purposes of determining the unitrust amount for year following the adjustment year.

E. **[Insert for QTIP, if your state does not have a statutory unitrust option so as to validate a unitrust payout for marital deduction purposes under the Proposed Regulations discussed in Section III, *supra*. If your state is a unitrust state, you may delete and re-letter subparagraphs once the regulations are final and in effect]** If in any trust year the net income of the trust exceeds the unitrust amount, such excess net income shall be distributed to my \_\_\_\_\_ at least annually.

F. Computing Fair Market Value. All computations of the trust's fair market value, or the value of any contributions or distributions as set forth above, shall include accounting income and

principal, but no accruals shall be required. If the trust includes assets for which there is not a ready market, the trustee shall adopt such method of valuation as the trustee deems reasonable in its discretion under the circumstances. **[This allows a closely-held business interest or real estate to be placed in the trust, but the TRU is cumbersome for this type of asset.]**

G. Income earned in estate prior to trust funding. In addition to the unitrust amount as determined above, the net accounting income earned in my estate and allocable to the residue shall be paid to the trust, and distributed to my \_\_\_\_\_.

H. Source of distribution amounts. The unitrust amount shall be paid from net accounting income, then from any other ordinary income, then from net realized short term capital gains, next from net realized long term capital gains, and finally, from the principal of the trust.

**[If your state has a statutory unitrust with the foregoing ordering rule, it is clear under Prop. Reg. § 1.643(b) and Prop. Reg. § 1.643(e), Example 9, that the ordering rule will be respected once the Regulations are final. It is likely that if the foregoing ordering rule is in the governing instrument, rather than being a default provision in your state law, it will also be respected, provided that the ordering rule is not inconsistent with your state law. If this were not the case, computer modeling suggests that the payout rate should be lowered .25% to .35% to have a roughly equivalent possibility of preserving the value of the trust after the effect of taxes, expenses and inflation, assuming the trust has a portfolio with a current or stepped up cost basis, and perhaps twice that amount, or .50% to .70% for a trust with an extremely low cost basis portfolio.]**

I. Discretionary distributions of additional amounts. In addition to the unitrust amount as set forth above, my trustee shall distribute such additional amounts, if any, of accounting income, other ordinary income, capital gain or principal to my said \_\_\_\_\_ as the trustee deems advisable for my \_\_\_\_\_'s health, maintenance and support in h\_\_\_\_\_ accustomed standard of living, taking into

account other income or assets which are available to h\_\_\_\_\_.  
[**Comment: Discretionary distributions may be advisable for the same reasons as they are in any trust. Consider giving an independent trustee broader powers to enable beneficiary “to make estate planning gifts,” “for \_\_\_\_\_ welfare” or “for any purpose in which money is needed.”**]

J. Death of \_\_\_\_\_. On the death of my \_\_\_\_\_, the trustee shall [pay any accrued distribution amount to my \_\_\_\_\_’s personal representative, and] distribute the balance in said trust to my then living issue, per stirpes, subject to the Trust Continuation Provisions hereinafter.

K. Goal of trust [Optional: and Corporate Trustee’s Power to Alter Distribution Rate.] The goal of this trust is to provide an adequate and a relatively smooth flow of distributions, which distributions over the anticipated term of the trust may to the extent possible maintain or increase their real spending power after inflation. A second and related goal is to maintain or increase the real spending power of the trust both for the long term benefit of my \_\_\_\_\_ and also for the benefit of the remaindermen. It is my intent by using a Total Return Unitrust, which is designed to invest for total return, whether produced by accounting income, short-term or long-term capital gains, to eliminate any conflict the trustee might otherwise experience between attaining the two goals set forth above. The distribution rate has been set at \_\_\_\_\_ (\_\_\_\_ percent) percent based upon an expectation that over long periods of time, this distribution rate can be maintained and still have the distributions increase to [partially] offset [or more than offset] inflation. [Optional: **If three percent or less. If a higher rate is used, use “to offset inflation as much as possible.”**] If this goal is achieved, the trust estate will also have maintained (or increased) [Optional: **If three percent or less**] its real value after inflation. [Make sure the goals are practical given the rate you insert. It is not a fair goal to expect a real increase after inflation if you insert a rate of five percent or more.] These goals will not be attainable every year, but I hope they will be attained over the long term. I understand that to the extent discretionary distributions are made in addition to the distribution amount these economic

goals will be compromised. Nevertheless, the corporate trustee shall not be liable for its good faith exercise of judgment in distributing such funds.

**[Optional. In making a determination concerning discretionary distributions in addition to the distribution amount, my corporate trustee/trustee \_\_\_ may wish to take into account that the welfare and support of my \_\_\_\_\_ is the most important goal of these trusts, with the preservation and building of wealth for the next generation of secondary importance. Alternative: The Corporate Trustee may wish to take into account that my intent is to provide a permanent and increasing source of funds for the lifetime of my \_\_\_\_\_ and that the buildup of value be passed forward for the benefit of the remainder beneficiaries.]**

**[Optional. If, as a result of permanent, substantial, and fundamental changes in the investment marketplace, the corporate trustee, acting alone, becomes convinced that the goals of the trust as set forth above cannot be attained because of the specific percentage distribution rates used for the distribution amount, the corporate trustee shall have the discretion to change such rates. The foregoing is intended to provide flexibility to the corporate trustee only in the event of extraordinary and unforeseen change in the investment marketplace from those markets experienced during the 20th Century. The corporate trustee shall not be held liable for the good faith exercise or non-exercise of this power.]**

**(NOTE - Because the modeling of these trusts demonstrates that TRU's work well and predictably for the periods 1926-1998, 1960-1998 and 1973-1998, and in numerous rolling period analyses, it is not clear that this discretion is needed, or even wise. It may, however, give clients an added level of comfort - no small thing.)**

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

**[Customary Provisions Omitted]**

\* \* \*

B. **Investments.** To invest in any type of investment that plays an appropriate role in achieving the investment goals of the trust, which investment shall be considered as part of the total portfolio. It is my specific direction that no category or type of investment shall be prohibited. I specifically do not wish to limit the universe of trust investments in any way other than is dictated by the trustee's exercise of reasonable care, skill, and caution. In connection with the trustee's investment and management decisions with respect to this trust, the trustee is specifically entitled to take into account general economic conditions, the possible effect of inflation or deflation, the expected tax consequences of investment decisions or strategies, the role that each investment or course of action may play within the overall trust portfolio that may include financial assets, interests in closely-held enterprises, **[Note: consider valuation problems here]** tangible and intangible personal property, and real property; **[Note: valuation problem]** the expected total return from income and the appreciation of capital; other resources of the beneficiaries, the needs for liquidity, regularity of income and preservation or appreciation of capital, and the asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries. Nor shall my trustee be limited to any one investment strategy or theory, including modern portfolio theory, the efficient markets theory or otherwise, but should be free to consider any appropriate investment strategy or theory under all the circumstances.<sup>172</sup>

**[Insert for QTIP if your state does not have a statutory unitrust: Should the trustee invest in property which is unproductive, my spouse shall have the right to require the trustee to convert the same into productive property within a reasonable time.] [Consider provisions for personal use property such as residential real estate**

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<sup>172</sup> Concern expressed by Bob Freedman in his article was the basis for granting the trustee the express power to employ any appropriate investment strategy, not just the one that is currently most popular. Robert Freedman, *Proposed New Prudent Investor Rule*, PA. B. NEWS, Sept. 23, 1996, at 10.

**or tangible personal property. If such property is contemplated, it should presumably not be included in the market value of the trust for determining the distribution.]**

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

\* \* \*

I. Reformation. The corporate trustee, acting alone and in its sole discretion, shall have the power to reform this instrument, with or without Order of Court, in order to make any changes necessary so as to preserve and make the best use of the marital deduction for federal estate tax purposes, the exemption from generation-skipping transfer tax, or to carry out my intent regarding the allocation of capital gains to income as prescribed in this will. Any provisions of this will shall be interpreted or reformed so as to preserve these benefits and carry out my intent wherever possible, provided that such interpretation or reformation does not do violence to my primary intent to provide for my spouse and my children.

### **SUPPLEMENTAL TOTAL RETURN TRUST FORMS**

In addition to the Total Return Unitrust form set forth above, the following are excerpts from additional forms that may be of use to the drafter. In the interests of space conservation, only the portions of the trust

provisions which are unique (as opposed to the basic TRU form set forth above) are included.

### **Form 1 — Marital and Residuary Total Return Unitrusts Key Language**

#### Bequest and Funding of Marital TRU.

A. Formula Bequest. If my \_\_\_\_\_, \_\_\_\_\_, survives me, I give to the trustee \_\_\_\_\_ appointed hereinafter to hold in trust as the Marital Total Return Unitrust (“Marital” TRU) the minimum amount necessary to reduce my Federal Estate Tax to zero after the use of the applicable credit amount and any other credits available to my estate (exclusive of any credits the use of which would increase my total death taxes). This amount shall be computed as if all qualified terminable interests were elected as part of the marital deduction on my Federal Estate Tax Return, regardless of the election actually filed. This bequest may be satisfied with proceeds of life insurance or other assets paid directly to my trustee \_\_\_\_\_. The foregoing amount shall be determined taking into account any other assets passing to my \_\_\_\_\_ and qualifying for the marital deduction, whether such other assets pass under this will or otherwise, as well as any other deductions taken and allowed on my Federal Estate Tax return. If at the time of my death there is no Federal Estate Tax it is my intent that the entire amount be held as the Shelter TRU as set forth below. **[This last language is added to guard against ambiguity if at the time of testator’s death the Federal Estate Tax has been eliminated. The theory is that you might want all of the estate protected against further taxation or other risks in that event. This should be adapted to each client separately depending upon their intent and the drafter’s judgment.]**

B. Funding Terms. To the extent that the amount to be held as the Marital TRU is satisfied with property in kind, such property shall be distributed at its market value as of the date of distribution. There shall be excluded from the Marital TRU any property or the proceeds of any property which does not qualify for the marital deduction.

C. Income or Interest Prior to Funding. My Marital TRU shall be entitled to a pro-rata share of the income from the assets held in my estate prior to the complete funding of my Marital TRU equal to the average income return on all of the estate assets during the applicable period. **[Sample Pennsylvania provision: No statutory interest shall be paid in place of income under Section 3543(a) or Section 7187 (1) of the Probate, Estates and Fiduciaries Code, as amended. This eliminates the five percent interest requirement which is problematic both because it is too high and because it produces a bad tax result if municipal bonds are held in the estate.]**

D. Survivorship Presumption. If my \_\_\_\_\_ and I die under circumstances in which there is insufficient evidence of who was the survivor, it shall be conclusively presumed that \_\_\_\_\_ survived \_\_\_\_\_. **[Insert the presumption which is most beneficial. Generally, it is best for the wealthiest spouse to have predeceased to give maximum flexibility for tax saving disclaimers by “survivor’s” personal representative.]**

3. Bequest and Funding of Shelter TRU. I give the residue of my estate to my trustees to hold as my Credit Shelter Total Return Unitrust (“Shelter TRU”).

4. Marital and Shelter TRU Provisions. If my \_\_\_\_\_, \_\_\_\_\_, survives me, it is my intent to create two Total Return Unitrusts, one of them entitled the Marital TRU and the other, the Shelter TRU. Except as indicated below, the terms of both trusts shall be the same:

A. During \_\_\_\_\_’s life. My trustee\_\_\_ shall pay the unitrust amounts set forth below from both trusts to or for the benefit of my \_\_\_\_\_, during h\_\_\_ life, in quarter-annual installments.

B. Unitrust Rate. The unitrust rate from the Marital TRU shall be \_\_\_\_\_ (\_\_\_ percent) percent and the unitrust rate from the Shelter TRU shall be \_\_\_\_\_ (\_\_\_ percent) percent.

C. Unitrust Amount. The trustee \_\_\_ shall pay to my \_\_\_\_\_ in each year of each trust (“trust year”) during h\_\_\_ life an amount equal to the unitrust rate for that trust multiplied by the average of the fair market values of that trust as of the close of the first business day of the trust year (or the date of first funding for the first trust year) and the previous two trust years (or such lesser number of trust years as are available for the first two trust years). In the case of a short tax year, the unitrust distribution shall be calculated as set forth in subparagraph D. below. In the case of contributions to or distributions from the trust, the unitrust amount shall be determined as set forth in subparagraph E. below.

D. Short year. For a short tax year, the unitrust amount shall be based upon a prorated portion of the unitrust amount set forth above comparing the number of days in the short year to the number of days in the calendar year of which the short tax year is a part.

E. Contributions and Distributions. In a trust year in which assets are added to or distributed from the trusts (other than the unitrust amount and the first funding of the trust) (hereinafter “adjustment year”), the unitrust amount shall be increased (in the case of a contribution) or decreased (in the case of a distribution) by an amount equal to the unitrust rate for that trust times the fair market value of the assets contributed or distributed (as of the date or dates of the contribution or distribution), multiplied by a fraction, the numerator of which is the number of days from the contribution or distribution to the end of the calendar year and the denominator of which shall be the days in the calendar year. Further, the beginning year values for the adjustment year and the trust year immediately preceding the adjustment year (unless the adjustment year is the first year of the trust) shall be increased by the amount of such addition, or decreased by the amount of such distribution, for purposes of determining the unitrust amount for years following the adjustment year. **[This complicated language is needed to accommodate multi-year funding of trusts from estates and discretionary distributions, in light of the three-year smoothing rule.]**

F. Computing fair market value. All computations of each trust’s fair market value, or the value of any contributions or

distributions as set forth above, shall include accounting income and principal, but no accruals shall be required. If the trust includes assets for which there is not a ready market, the trustees shall adopt such method of valuation as they deem reasonable in their discretion under the circumstances. **[This allows a closely-held business interest or real estate to be placed in the trust, but the Total Return Unitrust may be undesirable for this type of asset.]**

G. Distribute all income in Marital TRU. If in any tax year of the Marital TRU the net income earned in the Marital TRU exceeds the unitrust amount, such excess net income shall be distributed to my \_\_\_\_\_ at least annually. **[Needed for non-unitrust states. See Notes to Basic Form.]**

H. Income earned in estate prior to trust funding. In addition to the unitrust amount as determined above for the Marital TRU and the Shelter TRU, the pro-rata share of income distributed to the Marital TRU under Paragraph 2. C. and the remaining income earned in my estate and distributed to the Residuary TRU, shall be distributed to my \_\_\_\_\_ from the Marital TRU and the Shelter TRU respectively.

I. Source of unitrust amounts. The unitrust amounts for both the Marital TRU and the Shelter TRU shall be paid from net accounting income. If the net accounting income is insufficient to satisfy the unitrust amount, the trustees shall pay the unitrust amount from any other ordinary income in the trust, and to the extent insufficient, the trustees shall pay any net realized short term capital gains as are needed to satisfy the unitrust amount. If the foregoing amounts are still insufficient, the trustees shall pay the unitrust amount from such net realized long-term capital gains as are needed to satisfy the unitrust amount, and if still insufficient, the balance needed shall be paid from the principal of the trust. **[If the trust has a situs in a state that has a statutory unitrust with the foregoing ordering rule, it is clear under Prop. Reg. § 1.643(b) and Prop. Reg. § 1.643(e), Example 9, that the ordering rule will be respected. It is likely that if the foregoing ordering rule is in the governing instrument, rather than being a default provision in the state law of the trust situs, that it will also be respected, provided that the ordering rule is not inconsistent with situs state law. If this**

were not the case, computer modeling suggests that the payout rate should be lowered .25% to .35% to have a roughly equivalent possibility of preserving the value of the trust after the effect of taxes, expenses and inflation, assuming the trust has a portfolio with a current or stepped up cost basis, and perhaps twice that amount, or .50% to .70% for a trust with an extremely low cost basis portfolio].

J. Discretionary distributions of additional amounts.

In addition to the unitrust amounts as set forth above, my trustee\_ shall distribute such additional amounts, if any, of accounting income, other ordinary income, capital gain or principal to my said \_\_\_\_\_ as the **corporate trustee, acting alone/the trustee** \_\_, deem\_\_ advisable for h\_\_ health, maintenance, and support in h\_\_ accustomed manner of living, and specifically including educational expenses h\_\_ may incur either for h\_\_self or our issue, and taking into account other assets and income otherwise available to h\_\_ and such issue. Provided, further, that my trustee\_\_ shall first utilize the trust assets of the Marital TRU prior to distributing any such sums from the Shelter TRU.

K. Goals of trusts [Optional. and corporate trustee's power to alter distribution rates.] My goals concerning these trusts include the provision of a relatively smooth flow of distributions to my \_\_\_\_\_, which distributions over the anticipated term of the trusts may maintain or increase their real spending power after inflation. A second and related goal is to maintain or increase the real spending power of the trust corpus both for the long-term benefit of my \_\_\_\_\_ and also for the benefit of the remaindermen. It is my intent by using totalreturn unitrusts, which is designed to invest for total return, whether produced by accounting income, short term and long term capital gains, to eliminate any conflict the trustees might otherwise experience in selecting investments consistent with attaining the two goals set forth above. I have set the unitrust rate at \_\_\_\_\_ (\_\_\_ percent) percent for the Marital TRU and \_\_\_\_\_ (\_\_\_ percent) percent for the Residuary TRU based upon an expectation that over long periods of time, these unitrust rates can be maintained and still have the distributions increase to sufficiently offset inflation, though by utilizing a higher unitrust rate for the Marital TRU, I recognize that such growth will not be as achievable in that trust as it may be for my Residuary TRU. I

further recognize that these goals will not be attainable every year, and may not be even over the long term, even if my trustee\_ act\_ with appropriate skill, care and caution. I further understand that to the extent discretionary distributions are made in addition to the unitrust amount that these economic goals will be compromised. Nevertheless, the corporate trustee shall not be liable for its good faith exercise of judgment in distributing such funds.)

**[Select whichever option reflects best the settlor's intent:**

**Option 1: The corporate trustee may wish to take into account that my primary goal is to benefit my \_\_\_\_\_ during h\_\_ lifetime and that the buildup of funds for the next generation is of secondary importance. OR**

**Option 2: The corporate trustee may wish to take into account that my intent is to provide a permanent and increasing source of funds for the lifetime of my \_\_\_\_\_ and that the buildup of value to be passed forward into the next generations is of considerable importance.]**

**[Optional. If the corporate trustee becomes convinced that the unitrust rate established for h\_\_ will not be sufficient to satisfy h\_\_ needs under the ascertainable standards set forth in subparagraph J. above, and would otherwise require a continuing exercise of that discretionary distribution power, then the corporate trustee may increase the unitrust rate to satisfy h\_\_ needs pursuant to those standards for as long as necessary, provided that the unitrust rate shall not be increased to a rate in excess of seven (seven percent) percent. The corporate trustee shall not be held liable for the good faith exercise or non-exercise of this power. ]**

**Form 2 - Residuary Total Return Unitrust With Optional “No-Drop” Language, Fully Discretionary Trust for Children to Age 25 and Indexed Annuity Trust for Children Over Age 25.**

Residuary Total Return Unitrust. I give the residue of my estate to my trustee\_ to hold as the Residuary Total Return Unitrust (“Residuary TRU”) under the following provisions:

A. During \_\_\_\_\_’s life. My trustee\_\_ shall pay the unitrust amount set forth below to or for the benefit of my \_\_\_\_\_, during h\_\_ life, in quarter-annual installments.

B. Unitrust amount. The trustees shall pay to my \_\_\_\_\_ in each year of this trust (“trust year”) an amount equal to \_\_\_\_\_ (\_\_\_ percent) percent of the average of the fair market values of the trust as of the close of the first business day of the trust year (or the date of first funding for the first trust year) and the two previous trust years (or such lesser number of trust years as are available for the first two years of the trust). In the case of a short trust year, the unitrust amount shall be calculated as set forth in paragraph C. below. In the case of contributions to or distributions from the trust, the unitrust amount shall be determined as set forth in paragraph D. below.

**[Optional “no drop”language. The unitrust amount shall not be less than the unitrust amount in the immediately preceding trust year except in the case of a short year, or in an adjustment year or the year immediately following an adjustment year where the adjustment is caused by an additional distribution from the trust as set forth in paragraph D. below. In such case, the unitrust amount can decrease, but only by an amount equal to the adjustment or in the case of the following year by the unitrust rate multiplied by the additional distribution described in paragraph D. below.]**

C. Short year. For a short year, the unitrust amount shall be based upon a prorated portion of the unitrust amount set forth above comparing the number of days in the short year to the number of days in the calendar year of which the short year is a part.

D. Contributions and Distributions. In any year in which assets are added to or distributed from the trust (other than the unitrust amount and the initial funding of the trust) (hereinafter “adjustment year”), the unitrust amount shall be increased (in the case of a contribution) or decreased (in the case of a distribution) by an amount equal to \_\_\_\_ (\_\_\_ percent) percent **[insert unitrust rate]** times the fair market value of the assets contributed or distributed (as of the date or dates of the contribution or distribution), multiplied by a fraction, the numerator of which is the number of days from the contribution or distribution to the end of the calendar year and the denominator of which is the days in the calendar year. Further, the first business day fair market values for the adjustment year and the year immediately preceding the adjustment year (unless the adjustment year is the first year of the trust) shall be increased by the amount of such addition, or decreased by the amount of such distribution, for purposes of determining the unitrust amount for years following the adjustment year. **[This complicated language is needed to accommodate multi-year funding of the trust from estates or other sources and discretionary distributions, in light of the three-year smoothing rule.]**

E. Computing fair market value. All computations of the trust’s fair market value, or the value of any contributions or distributions as set forth above, shall include accounting income and principal, but no accruals shall be required. If the trust includes assets for which there is not a ready market, the trustees shall adopt such method of valuation as they deem reasonable in their sole discretion under the circumstances. **[See Notes to Basic Form concerning closely-held business or illiquid assets.]**

F. Income earned in estate prior to trust funding. In addition to the unitrust amount as determined above, the net accounting income earned in my estate or from some other source and allocable to this trust shall be paid to the trust, and distributed to my \_\_\_\_\_ in addition to the unitrust amount set forth above.

G. Source of unitrust amounts. The unitrust amounts for this trust shall be paid from net accounting income. If the net

accounting income is insufficient to satisfy the unitrust amount, the trustees shall pay the unitrust amount from any other ordinary income in the trust, and to the extent insufficient, my trustees shall pay any net realized short term capital gains as are needed to satisfy the unitrust amount. If the foregoing amounts are still insufficient, the trustee shall pay the unitrust amount from such net realized long term capital gains as are needed to satisfy the unitrust amount, and if still insufficient, the balance needed shall be paid from the principal of the trust. **[If your state has a statutory unitrust with the foregoing ordering rule, it is clear under Prop. Reg. § 1.643(b) and Prop. Reg. § 1.643(e), Example 9, that the ordering rule will be respected. It is likely that if the foregoing ordering rule is in the governing instrument, rather than being a default provision in your state law, that it will also be respected, provided that the ordering rule is not inconsistent with your state law. If this were not the case, computer modeling suggests that the payout rate should be lowered .25% to .35% to have a roughly equivalent possibility of preserving the value of the trust after the effect of taxes, expenses and inflation, assuming the trust has a portfolio with a current or stepped up cost basis, and perhaps twice that amount, or .50% to .70% for a trust with an extremely low cost basis portfolio.]**

H. Discretionary distributions of additional amounts.

In addition to the unitrust amount as set forth above, my trustees shall distribute such additional amounts, if any, of accounting income, other ordinary income, capital gain or principal to my said \_\_\_\_\_ as the corporate trustee, acting alone, deems advisable for h\_\_ health, maintenance, and support in h\_\_ accustomed manner of living, and specifically including educational expenses \_\_\_ may incur either for h\_\_self or our issue, and taking into account other assets and income otherwise available to h\_\_ and such issue.

I. Goal of trust [Optional. and Corporate Trustee's Power to Alter Unitrust Rate.] The goal of this trust is to provide a relatively smooth flow of distributions, which distributions over the anticipated term of the trust may maintain or increase their real spending power after inflation. A second and related goal is to maintain or increase

the real spending power of the trust both for the long term benefit of \_\_\_\_\_ and also for the benefit of the remaindermen. It is my intent by using a Total Return Unitrust, which is designed to invest for total return, whether produced by accounting income, short-term or long-term capital gains, to eliminate any conflict the trustees might otherwise experience in selecting investments consistent with attaining the two goals set forth above. The unitrust rate has been set at \_\_\_\_\_ (\_\_\_ percent) percent based upon an expectation that over long periods of time, this unitrust rate can be maintained and still have the distributions increase to sufficiently to offset inflation. **[Optional. If three percent or less. If a higher rate is used, use “to offset inflation as much as possible”.]** If this goal is achieved, the Trust will also have maintained **[Optional. If three percent or less “or increased”]** its real value after inflation. **[Make sure the goals are practical given the rate you insert. It is not a fair goal to expect a real increase after inflation if you insert a rate of five percent or more.]** These goals will not be attainable every year, and may not be even over the long term, even if my trustee acts with appropriate skill, care and caution. I understand that to the extent discretionary distributions are made in addition to the unitrust amount that these economic goals will be compromised. Nevertheless, the Corporate Trustee shall not be liable for the good faith exercise of judgment in distributing such funds.

**[Select whichever option reflects best the settlor’s intent:**

**Option 1: The Corporate Trustee may wish to take into account that my primary goal is to benefit my \_\_\_\_\_ during h\_\_ lifetime and that the buildup of funds for the next generation is of secondary importance; OR**

**Option 2: The Corporate Trustee may wish to take into account that my intent is to provide a permanent and increasing source of funds for the lifetime of my \_\_\_\_\_ and that the buildup of value to be passed forward into the next generations.]**

**[Optional. If the Corporate Trustee becomes convinced that the unitrust rate established for my \_\_\_\_\_ will not be sufficient to satisfy h\_\_ needs under the ascertainable standards set forth in**

**Subparagraph H above, and would otherwise require a continuing exercise of that discretionary distribution power, then the Corporate Trustee may increase the unitrust rate to satisfy h\_\_ needs pursuant to those standards for so long as necessary, provided that the unitrust rate shall not be increased to a rate in excess of seven (seven percent) percent. The Corporate Trustee shall not be held liable for the good faith exercise or non-exercise of this power.]**

J. Death of \_\_\_\_\_. On the death of my \_\_\_\_\_, the trustee\_\_\_ shall distribute the remaining trust account to such of the issue of my said \_\_\_\_\_ and me, in such proportions and subject to such trusts and conditions as my said \_\_\_\_\_ shall appoint in h\_\_ will by specific reference hereto, or, if such power is not exercised in full, the unappointed amount shall be divided into such number of equal shares as I have children then living, and deceased children with issue then living. The share of each such deceased child shall be distributed to his or her living issue, per stirpes. The share of each living child shall be held in a separate trust as set forth below.

K. Trusts for Children. The trustee shall hold and distribute the trusts for each of our children as follows:

(1) Child Under Twenty-Five (25) Years Old. Until our said child attains the age of Twenty-Five (25) years, my trustee\_\_\_ shall pay to or for the benefit of such child such portion of the income and principal thereof in the sole discretion of my corporate trustee as may be advisable for our child's comfort, maintenance, support, health care expenses and complete education, including vocational or post-graduate study. I direct that any payments during such child's minority shall be made without the intervention of a guardian of the estate and the receipt of such person as may be selected by my trustee\_\_\_ to disburse the same (including the individual trustee) shall be a sufficient release. I further authorize my corporate trustee, acting alone and in its discretion, to make payments for my child's benefit to the person having custody of my child to defray any and all costs associated with caring for my said child, including additional housing expenses if such is incurred. It is my intent hereby to insure that the family caring for my child shall bear no increased

financial burden as a result of undertaking that important role. Any excess income shall be accumulated prior to the beneficiary's attaining the age of Twenty-Five (25) years and added to principal.

(2) Child Over Twenty-Five (25) Years Old - Indexed Annuity Trust. After a child of ours has reached the age of Twenty-Five (25) years, the trustee\_ shall pay to him or her or for his or her benefit an annuity in quarter-annual installments equal to \_\_\_\_\_ (\$\_\_\_\_\_) dollars per year, as adjusted annually to reflect any increase in the consumer price index for all urban consumers from the date of this instrument (\_\_\_\_\_ as of \_\_\_\_\_ on the 1967 scale) to the first day of the calendar year in which the annuity is paid. If the above index is unavailable for any period in which this trust is in operation, the trustee shall select such index of general inflation as may most closely resemble the index referenced above. The annuity amount for any short year of the trust, including the first year, shall be prorated.

(3) Source of Annuity Amounts. The indexed annuity shall be paid from net accounting income. If the net accounting income is insufficient to satisfy the indexed annuity, the trustee shall pay the indexed annuity from any other ordinary income not allocated to accounting income. If the said other ordinary income is still insufficient, the trustee shall pay such net realized short term capital gains as are needed to satisfy the indexed annuity, and if still insufficient, the trustee shall pay such net realized long term capital gains as are needed to satisfy the indexed annuity. If, after paying out the other ordinary income, the short term and long term capital gains to income, the amount is still insufficient to pay the indexed annuity, the balance needed shall be paid from the principal of the trust. **[If your state has a statutory unitrust with the foregoing ordering rule, it is very likely that under Prop. Reg. § 1.643(b) and Prop. Reg. § 1.643(e), Example 9, the ordering rule will be respected, if the foregoing ordering rule is in the governing instrument, even though this is not a unitrust, since it is a consistent method of allocating capital gains and it is consonant with the provisions of your state law. It seems likely that even without an express provision in your state law such a provision may be respected, provided that the ordering rule is not inconsistent with**

**your state law. If this were not the case, computer modeling suggests that the payout rate should be lowered .25% to .35% to have a roughly equivalent possibility of preserving the value of the trust after the effect of taxes, expenses and inflation, assuming the trust has a portfolio with a current or stepped up cost basis, and perhaps twice that amount, or .50% to .70% for a trust with an extremely low cost basis portfolio.]**

(4) Discretionary distributions of additional amounts. In addition to the annuity amount set forth above, my trustee\_\_ may distribute such additional amounts, if any, of accounting income, other ordinary income, capital gain or principal to such child as the corporate trustee, acting alone, deems necessary, but only for educational and health care purposes which cannot be met from other sources of income or assets. It is my intent in creating this trust that the annuity provided for above shall be sufficient to augment our child's earnings to a more comfortable level during the early years of his or her career. The corporate trustee should consider the exercise of its discretion in light of my intent to encourage my child's initiative, education, and self-reliance.

(5) Rights of Withdrawal. Upon attaining the age of \_\_\_\_\_ (\_\_) years and thereafter, my child may withdraw one-half of the trust corpus, and upon attaining the age of \_\_\_\_\_ (\_\_) years, my child may withdraw all of the remaining trust corpus.

(6) Death of Child. In the event of my child's death, before the trust is fully distributed, my trustees shall pay the remaining balance to any one or more of such child's spouse or issue, and subject to such trusts and conditions as such child shall appoint and direct by his or her last will and testament by specific reference hereto, and any portion not so appointed shall be distributed to such child's living issue, per stirpes, subject to the trust continuation provisions set forth hereinafter, and if none, then to my issue then living, per stirpes, provided that the share for any of such issue for whom a trust is held hereunder shall be added to such trust share and administered as though an original part thereof. The annuity amount shall not be increased as a result of any such addition.

**Form 3 - Marital QTIP Total Return Unitrust With Discretionary Credit Shelter Trusts.**

2. Marital Total Return Unitrust.

A. Formula Bequest. If my \_\_\_\_\_, \_\_\_\_\_, survives me, I give to the trustee \_\_\_\_\_ appointed hereinafter to hold in trust as the Marital Total Return Unitrust ("Marital TRU") the minimum amount necessary to reduce my Federal Estate Tax to zero after the use of the applicable credit amount (taking into account the applicable exclusion amount in 2002 or later) and any other credits available to my estate (exclusive of any credits the use of which would increase my total death taxes). This amount shall be computed as if all qualified terminable interests were elected as part of the marital deduction on my Federal Estate Tax Return, regardless of the election actually filed. This bequest may be satisfied with proceeds of life insurance or other assets paid directly to my trustee \_\_\_\_\_. The foregoing amount shall be determined taking into account any other assets passing to my \_\_\_\_\_ and qualifying for the marital deduction, whether such other assets pass under this will or otherwise, as well as any other deductions taken and allowed on my Federal Estate Tax Return. If at the time of my death there is no Federal Estate Tax it is my intent that the entire amount be held as the Shelter TRU as set forth below. **[This last language is added to guard against ambiguity if at the time of testator's death the Federal Estate Tax has been eliminated. The theory is that you might want all of the estate protected against further taxation or other risks in that event. This should be adapted to each client separately depending upon their intent and the drafter's judgment.]**

B. Funding Terms. To the extent that the amount to be held as the Marital TRU is satisfied with property in kind, such property shall be distributed at its market value as of the date of distribution. There shall be excluded from the Marital TRU any property or the proceeds of any property which does not qualify for the marital deduction.

C. Income or Interest Prior to Funding. My Marital

TRU shall be entitled to a prorata share of the income from the assets held in my estate prior to the complete funding of my Marital TRU equal to the average income return on all of the estate assets during the applicable period. **[Pennsylvania Note: No interest shall be paid under Section 3543(a) or Section 7187 (1) of the Probate, Estates and Fiduciaries Code, as amended. This eliminates the five percent interest requirement which is problematic both because it is too high and because it produces a bad tax result if municipal bonds are held in the estate.]**

D. Survivorship Presumption. If my \_\_\_\_\_ and I die under circumstances in which there is insufficient evidence of who was the survivor, it shall be conclusively presumed that \_\_\_\_\_ survived \_\_\_\_\_. **[Insert the presumption which is most beneficial. Generally, it is best for the wealthiest spouse to have predeceased to give maximum flexibility for tax saving disclaimers by “survivor’s” personal representative.]**

E. Marital TRU. During my \_\_\_\_\_’s life, my trustee\_\_\_ shall pay the unitrust amount set forth below to or for the benefit of my \_\_\_\_\_, during h\_\_\_ life, in quarter-annual installments.

F. Unitrust Amount. The unitrust amount shall equal \_\_\_\_\_ (\_\_\_ percent) percent of the average of the fair market values of the Marital TRU as of the close of the first business day of the Marital TRU’s year (“trust year”) (or the date of first funding for the first trust year) and the two previous trust years (or such lesser number of trust years as are available for the first three tax years of the Marital TRU). In the case of a short tax year, the unitrust amount shall be calculated as set forth in subparagraph G. below. In the case of contributions to or distributions from the Marital TRU, the unitrust amount shall be determined as set forth in subparagraph H. below. If in any trust year, the net income earned in the Marital TRU exceeds the unitrust amount, such excess net income shall be distributed to my \_\_\_\_\_ at least annually. **[If possible, the unitrust amount for the Marital TRU should be chosen based on the overall total needs of the surviving spouse so that the**

**lifetime benefits would be taken entirely from the trust as taxable in the life beneficiary's estate.]**

G. Short year. For a short year, the unitrust amount shall be based upon a prorated portion of the unitrust amount set forth above comparing the number of days in the short year to the number of days in the calendar year of which the short year is a part.

H. Contributions and Distributions. In any year in which assets are added to or distributed from the trust (other than the unitrust amount and the initial funding of the trust) (hereinafter "adjustment year"), the unitrust amount shall be increased (in the case of a contribution) or decreased (in the case of a distribution) by an amount equal to \_\_\_\_ (\_\_\_ percent) percent **[insert unitrust rate]** times the fair market value of the assets contributed or distributed (as of the date or dates of the contribution or distribution), multiplied by a fraction, the numerator of which is the number of days from the contribution or distribution to the end of the calendar year and the denominator of which is the days in the calendar year. Further, the first business day fair market values for the adjustment year and the year immediately preceding the adjustment year (unless the adjustment year is the first year of the trust) shall be increased by the amount of such addition, or decreased by the amount of such distribution, for purposes of determining the unitrust amount for years following the adjustment year. **[This complicated language is needed to accommodate multi-year funding of the trust from estates or other sources and discretionary distributions, in light of the three-year smoothing rule.]**

I. Computing fair market value. All computations of the trust's fair market value, or the value of any contributions or distributions as set forth above, shall include accounting income and principal, but no accruals shall be required. If the trust includes assets for which there is not a ready market, the trustees shall adopt such method of valuation as they deem reasonable in their sole discretion under the circumstances.

J. Income earned in estate prior to trust funding. In addition to the unitrust amount as determined above, the net accounting

income earned in my estate or from some other source and allocable to this trust shall be paid to the trust, and distributed to my \_\_\_\_\_ in addition to the unitrust amount set forth above.

K. Source of unitrust amounts. The unitrust amounts for this trust shall be paid from net accounting income. If the net accounting income is insufficient to satisfy the unitrust amount, the trustee shall pay the unitrust amount from any other ordinary income in the trust, and to the extent insufficient, my trustees shall pay any net realized short term capital gains as are needed to satisfy the unitrust amount. If the foregoing amounts are still insufficient, the trustee shall pay the unitrust amount from such net realized long term capital gains as are needed to satisfy the unitrust amount, and if still insufficient, the balance needed shall be paid from the principal of the trust. **[If your state has a statutory unitrust with the foregoing ordering rule, it is clear under Prop. Reg. § 1.643(b) and Prop. Reg. § 1.643(e), Example 9, that the ordering rule will be respected. It is likely that if the foregoing ordering rule is in the governing instrument, rather than being default provision in your state law, it will also be respected, provided that the ordering rule is not inconsistent with your state law. If this were not the case, computer modeling suggests that the payout rate should be lowered .25% to .35% to have a roughly equivalent possibility of preserving the value of the trust after the effect of taxes, expenses and inflation, assuming the trust has a portfolio with a current or stepped up cost basis, and perhaps twice that amount, or .50% to .70% for a trust with an extremely low cost basis portfolio.]**

L. Discretionary distributions of additional amounts. In addition to the unitrust amount as set forth above, my trustees shall distribute such additional amounts, if any, of accounting income, other ordinary income, capital gain or principal to my said \_\_\_\_\_ as the corporate trustee, acting alone, deems advisable for h\_\_ health, maintenance, and support in h\_\_ accustomed manner of living, and specifically including educational expenses \_\_\_ may incur either for h\_\_self or our issue, and taking into account other assets and income otherwise available to h\_\_ and such issue.

M. Goal of trust [Optional. and Corporate Trustee's Power to Alter Unitrust Rate.] The goal of this trust is to provide a relatively smooth flow of distributions, which distributions over the anticipated term of the trust may maintain or increase their real spending power after inflation. A second and related goal is to maintain or increase the real spending power of the trust both for the long term benefit of \_\_\_\_ and also for the benefit of the remaindermen. It is my intent by using a Total Return Unitrust, which is designed to invest for total return, whether produced by accounting income, short-term or long-term capital gains, to eliminate any conflict the trustees might otherwise experience in selecting investments consistent with attaining the two goals set forth above. The unitrust rate has been set at \_\_\_\_\_ (\_\_\_ percent) percent based upon an expectation that over long periods of time, this unitrust rate can be maintained and still have the distributions increase to sufficiently to offset inflation. **[Optional. If three percent or less. If a higher rate is used, use "to offset inflation as much as possible".]** If this goal is achieved, the Trust will also have maintained **[Optional. If three percent or less "or increased"]** its real value after inflation. **[Make sure the goals are practical given the rate you insert. It is not a fair goal to expect a real increase after inflation if you insert a rate of five percent or more.]** These goals will not be attainable every year, and may not be even over the long term, even if my trustee acts with appropriate skill, care and caution. I understand that to the extent discretionary distributions are made in addition to the unitrust amount that these economic goals will be compromised. Nevertheless, the Corporate Trustee shall not be liable for the good faith exercise of judgment in distributing such funds.

**[Select whichever option reflects best the settlor's intent:**

**Option 1: The Corporate Trustee may wish to take into account that my primary goal is to benefit my \_\_\_\_\_ during h\_\_ lifetime and that the buildup of funds for the next generation is of secondary importance; OR**

**Option 2: The Corporate Trustee may wish to take into account that my intent is to provide a permanent and increasing source of funds for the lifetime of my \_\_\_\_\_ and that the buildup of value to**

be passed forward into the next generations.]

**[Optional. If the Corporate Trustee becomes convinced that the unitrust rate established for my \_\_\_\_\_ will not be sufficient to satisfy h\_\_ needs under the ascertainable standards set forth in Subparagraph H above, and would otherwise require a continuing exercise of that discretionary distribution power, then the Corporate Trustee may increase the unitrust rate to satisfy the h\_\_ needs pursuant to those standards for as long as necessary, provided that the unitrust rate shall not be increased to a rate in excess of seven (seven percent) percent. The Corporate Trustee shall not be held liable for the good faith exercise or non-exercise of this power.]**

N. Death of \_\_\_\_\_. On the death of my \_\_\_\_\_, the trustee shall pay any accrued or undistributed unitrust amount and, if applicable, excess net income from the Marital TRU to my said \_\_\_\_\_'s estate, and the remaining trust shall pass pursuant to the provisions set forth in my Residuary Trust at Paragraph 3.C. hereinafter.

3. Shelter Trust I give the residue of my estate to my trustees to hold as the Shelter Trust under the provisions set forth below.

A. During \_\_\_\_\_'s Life. During the life of my \_\_\_\_\_, \_\_\_\_\_, my trustees shall pay so much of the income or principal of the trust to or for the benefit of my \_\_\_\_\_, as my corporate trustee, acting alone and its sole discretion, shall deem advisable for [**h\_\_ health, maintenance and support in h\_\_ accustomed manner of living,**] [**Optional. any purpose whatsoever**] taking into account other sources of income or assets which might be available to h\_\_. Any undistributed income shall be added to principal and invested as such.

B. Goal of Trust. The primary goal of this trust is to preserve and build up value for the eventual benefit of my children and grandchildren, but it shall remain available for my \_\_\_\_\_ during h\_\_

lifetime to the extent needed. It is my desire that my \_\_\_\_\_'s own funds and then the Marital TRU be utilized first for my \_\_\_\_\_'s benefit prior to the use of the income and principal of this Shelter Trust.

**Form 4 - TRU CAP Index Trust.**

I give the residue of my estate to my trustee\_\_\_ to hold as the TRU CAP index trust under the following provisions:

A. During \_\_\_\_\_'s life. My trustee\_\_\_ shall pay the unitrust amount set forth below to or for the benefit of my \_\_\_\_\_, during h\_\_ life, in quarter-annual installments.

B. Unitrust amount. The trustees shall pay to my \_\_\_\_\_ in each tax year of this trust during h\_\_ life an amount ("unitrust amount") equal to the lesser of the Indexed Annuity and the TRU CAP amount as set forth below:

(1) Indexed Annuity. An amount equal to \_\_\_\_\_ (\$\_\_\_\_\_) per year as adjusted annually to reflect any increase in the consumer price index from the date of this instrument (\_\_\_\_\_ as of \_\_\_\_\_ on the 1967 scale) to the first day of the calendar year in which the annuity is paid. The annuity amount for any short year of the trust including the first year shall be prorated.

(2) TRU CAP Amount. An amount equal to \_\_\_\_\_ (\_\_\_ percent) percent of the average of the fair market values of the trust as of the close of the first business day of the trust year (or the date of first funding for the first trust year)("trust year") and the two previous trust years (or such lesser number of trust years as are available for the first two trust years). In the case of a short trust year, the TRU CAP amount shall be calculated as set forth in subparagraph C. below. In the case of contributions to or distributions from the trust, the TRU CAP amount shall be determined as set forth in subparagraph D. below.

C. Short year. For a short tax year, the unitrust amount shall be based upon a prorated portion of the unitrust amount set forth above comparing the number of days in the short tax year to the number of days in the calendar year of which the short tax year is a part.

D. Contributions and Distributions. In any year in which assets are added to or distributed from the trust (other than the unitrust amount and the initial funding of the trust) (hereinafter “adjustment year”), the unitrust amount shall be increased (in the case of a contribution) or decreased (in the case of a distribution) by an amount equal to \_\_\_\_ (\_\_\_ percent) percent **[insert TRU CAP amount]** times the fair market value of the assets contributed or distributed (as of the date or dates of the contribution or distribution), multiplied by a fraction, the numerator of which is the number of days from the contribution or distribution to the end of the calendar year and the denominator of which is the days in the calendar year. Further, the first business day fair market values for the adjustment year and the year immediately preceding the adjustment year (unless the adjustment year is the first year of the trust) shall be increased by the amount of such addition, or decreased by the amount of such distribution, for purposes of determining the TRU CAP amount for years following the adjustment year. **[This complicated language is needed to accommodate multi-year funding of the trust from estates or other sources and discretionary distributions, in light of the three-year smoothing rule.] [Note that contributions and distributions are factored into the equation for the TRU CAP amount, but not the indexed amount. An adjustment could be built into the index amount as well, but at the cost of even greater complexity.]**

E. Computing fair market value. All computations of the trust’s fair market value, or the value of any contributions or distributions as set forth above, shall include accounting income and principal, but no accruals shall be required. If the trust includes assets for which there is not a ready market, the trustees shall adopt such method of valuation as they deem reasonable in their sole discretion under the circumstances. **[This allows a closely-held business interest or real estate to be placed in the trust, but the TRU CAP Index Trust is not designed for this type of asset.]**

F. Income earned in estate prior to trust funding. In addition to the distribution amount as determined above, the net accounting income earned in my estate or from some other source and allocable to this trust shall be paid to the trust, and distributed to my \_\_\_\_ .

G. Source of unitrust amounts. The unitrust amount for the TRU CAP Index Trust shall be paid from net accounting income. If the net accounting income is insufficient to satisfy the unitrust amount, the trustees shall pay the unitrust amount from any other ordinary income in the trust, and to the extent insufficient, my trustees shall pay any net realized short term capital gains as are needed to satisfy the unitrust amount. If the foregoing amounts are still insufficient, the trustee shall pay the unitrust amount from such net realized long term capital gains as are needed to satisfy the unitrust amount, and if still insufficient, the balance needed shall be paid from the principal of the trust. **[If your state has a statutory unitrust with the foregoing ordering rule, it is likely that because of Prop. Reg. § 1.643(b) and Prop. Reg. § 1.643(e), Example 9, the ordering rule will be respected, at least in any year in which the TRU CAP amount is the amount distributed. It is likely that if the foregoing ordering rule is in the governing instrument, rather than being default provision in your state law, it will also be respected, provided that the ordering rule is not inconsistent with your state law. If this were not the case, computer modeling suggests that the payout rate should be lowered .25% to .35% to have a roughly equivalent possibility of preserving the value of the trust after the effect of taxes, expenses and inflation, assuming the trust has a portfolio with a current or stepped up cost basis, and perhaps twice that amount, or .50% to .70% for a trust with an extremely low cost basis portfolio].**

H. Discretionary distributions of additional amounts. In addition to the unitrust amount as set forth above, my trustees shall distribute such additional amounts, if any, of accounting income, other ordinary income, capital gain or principal to my said \_\_\_\_\_ as the corporate trustee, acting alone, deems advisable for h\_\_ health, maintenance, and support in h\_\_ accustomed manner of living, and specifically including educational expenses \_\_\_ may incur either for h\_\_self or our issue, and taking into account other assets and income otherwise available to h\_\_ and such issue.

I. Goal of trust. The goal of this trust is to provide a very smooth flow of distributions, which will match the initial real spending power after inflation. A second and related goal is to be sure that the trust

does not largely or complete deplete itself prior to its termination. This is the reason for the TRU CAP provisions of this trust as set forth above. The TRU CAP unitrust rate has been set at \_\_\_\_\_ (\_\_\_\_\_ percent) based upon an expectation that over long periods of time one cannot expect to distribute more than this amount and still have the distributions increase sufficiently to offset inflation without depletion of the trust. **[Based upon historical modeling, it is submitted that ten percent is a sensible maximum for the “CAP” on the TRU CAP Index Trust. It is even more important that the index payment be set carefully and low enough to give a reasonable prospect that the trust will not be depleted. While the TRU CAP will avoid complete depletion, it will not avoid a bad result to the remaindermen if the TRU CAP is in effect for a very long period of time, if the TRU CAP payout is too high to allow the value of the trust to preserve itself. It is suggested that the index payment should be set not higher than three percent to four percent if the trust is to last longer than ten to fifteen years.]**

**Form 5 - Three Trust GST Plan Total Return Exempt and Nonexempt Marital TRU and Discretionary Credit Shelter Trust.**

(3) Marital TRU. During my \_\_\_\_\_'s life, my trustees shall administer the Exempt Marital Share and Nonexempt Marital Share as Total Return Unitrusts and shall refer to them hereinafter as the Exempt Marital TRU and the Nonexempt Marital TRU. Except as indicated below, the terms of both trusts shall be the same.

(a) During \_\_\_\_\_'s Life. My trustees shall pay the unitrust amount set forth below from both trusts to or for the benefit of my \_\_\_\_\_, during h\_\_\_\_\_ life, in quarter-annual installments.

(b) Unitrust Rate. The unitrust rate from the Exempt Marital TRU shall be \_\_\_\_\_ (\_\_\_\_ percent) percent and the unitrust rate from the Nonexempt Marital TRU shall be \_\_\_\_\_ (\_\_\_\_ percent) percent.

(c) Unitrust Amount. The trustees shall pay to my \_\_\_\_\_ in each year of each trust ("trust year") during h\_\_\_\_\_ life an amount equal to the unitrust rate for that trust multiplied by the average of the fair market values of that trust as of the close of the first business day of the trust's calendar year (or the date of first funding for the first trust year) and the two previous trust years (or such lesser number of trust years as are available for the first two trust years). In the case of a short trust year, the distribution shall be calculated as set forth in subparagraph (d) below. In the case of contributions to or distributions from the trust, the unitrust amount shall be determined as set forth in subparagraph (e) below. If in any tax year of the trusts, the net income earned in the trust exceeds the unitrust amount, such excess net income shall be distributed to my \_\_\_\_\_ at least annually. **[Needed for non-unitrust states. See Notes to Basic Form]**

(d) Short year. For a short trust year, the unitrust amount for each trust shall be based upon a prorated portion of the unitrust amount set forth above comparing the number of days in the short tax year to the number of days in the calendar year of which the short trust

year is a part.

(e) Contributions and Distributions. In any year in which assets are added to or distributed from the trust (other than the unitrust amount and the initial funding of the trust) (hereinafter “adjustment year”), the unitrust amount shall be increased (in the case of a contribution) or decreased (in the case of a distribution) by an amount equal to \_\_\_\_ (\_\_\_ percent) percent [**insert unitrust rate**] times the fair market value of the assets contributed or distributed (as of the date or dates of the contribution or distribution), multiplied by a fraction, the numerator of which is the number of days from the contribution or distribution to the end of the calendar year and the denominator of which is the days in the calendar year. Further, the first business day fair market values for the adjustment year and the year immediately preceding the adjustment year (unless the adjustment year is the first year of the trust) shall be increased by the amount of such addition, or decreased by the amount of such distribution, for purposes of determining the unitrust amount for years following the adjustment year. [**This complicated language is needed to accommodate multi-year funding of the trust from estates or other sources and discretionary distributions, in light of the three-year smoothing rule.**]

(f) Computing fair market value. All computations of the trust’s fair market value, or the value of any contributions or distributions as set forth above, shall include accounting income and principal, but no accruals shall be required. If the trust includes assets for which there is not a ready market, the trustees shall adopt such method of valuation as they deem reasonable in their sole discretion under the circumstances. [**This allows a closely-held business interest or real estate to be placed in the trust, but the Total Return Unitrust is less effective for this type of asset.**]

(g) Income earned in estate prior to trust funding. In addition to the unitrust amount as determined above, the net accounting income earned in my estate and allocable to the Marital Exempt TRU and the Marital Non-Exempt TRU shall be paid to that trust, and distributed to my \_\_\_\_\_ in addition to the unitrust amount set forth above.

(h) Source of unitrust amounts. The unitrust amounts for both the Marital TRU and the Residuary TRU shall be paid from net accounting income. If the net accounting income is insufficient to satisfy the unitrust amount, the trustee shall pay the unitrust amount from any other ordinary income in the trust, and to the extent insufficient, my trustees shall pay any net realized short term capital gains as are needed to satisfy the unitrust amount. If the foregoing amounts are still insufficient, the trustee shall pay the unitrust amount from such net realized long term capital gains as are needed to satisfy the unitrust amount, and if still insufficient, the balance needed shall be paid from the principal of the trust. **[If your state has a statutory unitrust with the foregoing ordering rule, it is clear under Prop. Reg. § 1.643(b) and Prop. Reg. § 1.643(e), Example 9, that the ordering rule will be respected. It is likely that if the foregoing ordering rule is in the governing instrument, rather than being default provision in your state law, that it will also be respected, provided that the ordering rule is not inconsistent with your state law. If this were not the case, computer modeling suggests that the payout rate should be lowered .25% to .35% to have a roughly equivalent possibility of preserving the value of the trust after the effect of taxes, expenses and inflation, assuming the trust has a portfolio with a current or stepped up cost basis, and perhaps twice that amount, or .50% to .70% for a trust with an extremely low cost basis portfolio.]**

(i) Discretionary distributions of additional amounts. In addition to the unitrust amount as set forth above, my trustees shall distribute such additional amounts, if any, of accounting income, other ordinary income, capital gain or principal to my said \_\_\_\_\_ as the corporate trustee, acting alone, deems advisable for h\_\_ health, maintenance, and support in h\_\_ accustomed manner of living, and specifically including educational expenses \_\_\_ may incur either for h\_\_self or our issue, and taking into account other assets and income otherwise available to h\_\_ and such issue. Provided, however, it is my direction that such additional distributions be made from my Non-Exempt Marital TRU to the extent possible prior to the distributions of such additional discretionary distributions from the Exempt Marital TRU.

(j) Goals of trusts. My goals concerning these trusts

include the provision of a relatively smooth flow of distributions to my \_\_\_\_\_, which distributions over the anticipated term of the trusts may maintain to the extent practicable their real spending power after inflation. A second and related goal is to maintain the real spending power of the trust corpus both for the long term benefit of my \_\_\_\_\_ and also for the benefit of my children and grandchildren. It is my intent by using total return unitrusts which do not distinguish in investment goal between the production of accounting income and short and long term capital gains, to eliminate any conflict the trustees might otherwise experience between attaining the two goals set forth above. I have set a unitrust rate of \_\_\_\_\_ (\_\_\_\_ percent) percent for the Nonexempt Marital TRU and \_\_\_\_\_ (\_\_\_\_ percent) percent for the Exempt Marital TRU based upon my hope that over long periods of time, these unitrust rates can be maintained and still have the distributions increase in the aggregate sufficiently to offset inflation, though by utilizing a higher unitrust rate for the Nonexempt Marital TRU, I recognize that such growth will not be as achievable for that trust as it may be for the Exempt Marital TRU. In connection with such discretionary distributions, the corporate trustee may wish to take into account that my primary goal for the Exempt and Nonexempt Marital TRU is to benefit my \_\_\_\_\_ during h\_\_\_\_\_ lifetime and that the availability of funds for the next generations is of secondary importance for these trusts. I further recognize that these goals will not be attainable every year, and may not be even over the long term, even if my trustees act with appropriate skill, care and caution. I further understand that to the extent discretionary distributions are made in addition to the unitrust amount that these economic goals may be compromised. Nevertheless, the corporate trustee shall not be liable for its good faith exercise of judgment in distributing such funds.

**[Select whichever option reflects best the settlor's intent:**

**Option 1: The corporate trustee may wish to take into account that my primary goal is to benefit my \_\_\_\_\_ during h\_\_\_\_ lifetime and that the buildup of funds for the next generation is of secondary importance. OR**

**Option 2: The corporate trustee may wish to take into account that my intent is to provide a permanent and increasing source of funds**

**for the lifetime of my \_\_\_\_\_ and that the buildup of value to be passed forward into the next generations is of considerable importance.]**

(4) Payments on \_\_\_\_\_'s Death. On the death of my \_\_\_\_\_, the trustees shall pay any accrued or undistributed distribution amount and, if applicable, excess net income from the Exempt Marital TRU and the Nonexempt Marital TRU to my said \_\_\_\_\_'s estate. The trustees shall pay to my \_\_\_\_\_'s executor or directly to the taxing authority from the Nonexempt Marital TRU such amount, if any, as my \_\_\_\_\_'s executor certifies to be the additional death taxes resulting from the inclusion of the Exempt Marital TRU and the Nonexempt Marital TRU in my \_\_\_\_\_'s estate for death tax purposes.

(5) Distribution of Exempt and Nonexempt Marital TRUs After \_\_\_\_\_'s Death. After the payments described in (4) above are made subsequent to my \_\_\_\_\_'s death, the remaining Exempt and Nonexempt Marital TRU shall be distributed to such of the members of the class consisting of my issue, in such shares and subject to such trusts and conditions as my \_\_\_\_\_ shall appoint and direct in h\_\_\_\_\_ will by specific reference hereto and specific reference to the Exempt Marital TRU, the Nonexempt Marital TRU, or both. Any unappointed amount shall be held, administered and distributed as set forth in paragraph 3. below, for provisions following \_\_\_\_\_'s death or if \_\_\_\_\_ predeceases.

(6) Right to Disclaim. If my \_\_\_\_\_ disclaims h\_\_\_\_\_ interest in any portion of the Marital Share, such portion shall pass to my living issue, per stirpes. If my \_\_\_\_\_ dies before accepting any benefits, h\_\_\_\_\_ personal representative shall have the right to disclaim h\_\_\_\_\_ interest in all or a portion of the Marital Share of my estate.

4. Credit Shelter Share. The Credit Shelter Share shall be held and administered as a separate trust and referred to as the Credit Shelter Trust as follows:

(a) During \_\_\_\_\_'s Life. During the lifetime

of my \_\_\_\_\_, \_\_\_\_\_, the trustees shall pay so much of the income or principal to or for the benefit of my said \_\_\_\_\_, as my corporate trustee, acting alone and in its discretion, shall deem advisable for [**h\_\_\_\_\_ health, maintenance and support in h\_\_\_\_\_ accustomed manner of living,**] [**Optional: or for any purpose whatsoever**] taking into account other sources of income or assets which are available to h\_\_\_\_\_. Any undistributed income shall be added to principal and invested as such.

(b) Goal of trust. The primary goal of this trust is to preserve and build up value for the benefit of my children and grandchildren, but it shall remain available for my \_\_\_\_\_ during h\_\_\_\_\_ lifetime to the extent needed. It is my desire that my \_\_\_\_\_'s own funds, the Nonexempt Marital TRU and the Exempt Marital TRU be utilized first for the benefit of my \_\_\_\_\_ before the use of these trust funds for h\_\_\_\_\_ benefit.

(c) Upon \_\_\_\_\_'s Death. Upon the death of my \_\_\_\_\_, \_\_\_\_\_, the remaining trust shall be distributed to such of the members of the class consisting of my issue, in such shares and subject to such trusts and conditions as my \_\_\_\_\_ shall appoint and direct in h\_\_\_\_\_ will by specific reference to the Credit Shelter Trust. Any unappointed amount shall be held, administered and distributed as set forth in Paragraph \_\_\_\_\_ below.

**Form 6. Marital/Credit Shelter Ordered TRU Approach Under EGTRRA**

3. Marital Total Return Unitrust.

A. Formula Bequest. If my \_\_\_\_\_, \_\_\_\_\_, survives me, I give to my trustees appointed hereinafter to hold as the Marital Total Return Unitrust ("Marital TRU") the minimum amount necessary to reduce my Federal Estate Tax to zero or the smallest possible amount after the use of the applicable credit amount and any other credits available to my estate (exclusive of any credits the use of which would increase my total death taxes). The foregoing amount shall be determined taking into account any other assets passing to my \_\_\_\_\_ and qualifying for the marital deduction, whether such other assets pass under this will or otherwise, as well as any other deductions taken and allowed on my Federal Estate Tax Return. This amount shall be computed as if all qualified terminable interests were elected as part of the marital deduction on my Federal Estate Tax Return, regardless of the election actually filed. This bequest may be satisfied with proceeds of life insurance or other assets paid directly to my trustees. If at the time of my death there is no Federal Estate Tax it is my intent that the entire amount be held as the Shelter TRU as set forth below. **[This last language is added to guard against ambiguity if at the time of testator's death the Federal Estate Tax has been eliminated. The theory is that you might want all of the estate protected against further taxation or other risks in that event. This should be adapted to each client separately depending upon their intent and the drafter's judgment.]**

B. Funding Terms. To the extent that the amount to be held as the Marital TRU is satisfied with property in kind, such property shall be distributed at its market value as of the date of distribution. There shall be excluded from the Marital TRU any property or the proceeds of any property which does not qualify for the marital deduction.

C. Income or Interest Prior to Funding. My Marital TRU shall be entitled to a pro-rata share of the income from the assets held in my estate prior to the complete funding of my Marital TRU equal to the

average income return on all of the estate assets during the applicable period. No statutory interest shall be paid in place of income under applicable state law.

D. Survivorship Presumption. If my \_\_\_\_\_ and I die under circumstances in which there is insufficient evidence of who was the survivor, it shall be conclusively presumed that \_\_\_\_\_.

4. Bequest and Funding of Credit Shelter Total Return Unitrust. I give the residue of my estate to my trustees to hold as the Credit Shelter Total Return Unitrust (“Credit Shelter TRU”).

5. Marital and Credit Shelter TRU Provisions. If my \_\_\_\_\_, \_\_\_\_\_, survives me, it is my intent to create two Total Return Unitrusts, the Marital TRU and the Credit Shelter TRU. Except as indicated below, the terms of both trusts shall be the same:

A. During \_\_\_\_\_’s Life. My trustees shall pay the unitrust amount set forth below to or for the benefit of my \_\_\_\_\_, \_\_\_\_\_, during h\_\_ life, in quarter-annual installments.

B. Unitrust Amount. My trustees shall pay to my said \_\_\_\_\_ in each year of these trusts (“trust year”) a unitrust amount equal to \_\_\_\_ ( \_\_ percent) percent of the average of the combined fair market values of the Marital TRU and the Credit Shelter TRU as of the close of the first business day of the trust year (or the date of first funding for the first trust year) and the two previous trust years (or such lesser number of trust years as are available for the first two-years of the trusts). In the case of a short trust year, the unitrust amount shall be calculated as set forth in subparagraph C. below. In the case of contributions to or distributions from the trusts, the unitrust amount shall be determined as set forth in subparagraph D. below; provided, however, that the entire unitrust amount shall be paid from the Marital TRU and nothing shall be paid from the Credit Shelter TRU unless or until the Marital TRU is exhausted. If there is no Marital TRU or after the Marital TRU is exhausted, the unitrust

amount shall be paid from the Credit Shelter TRU.

C. Short Year. For a short trust year, the unitrust amount shall be based upon a prorated portion of the unitrust amount set forth above comparing the number of days in the short trust year to the number of days in the calendar year in which the short trust year is a part.

D. Contributions and Distributions. In a trust year in which assets are added to or distributed from the trusts (other than the unitrust amount and the first funding of the trusts) (hereinafter “adjustment year”), the unitrust amount shall be increased (in the case of a contribution) or decreased (in the case of a distribution) by an amount equal to the unitrust rate set forth above times the fair market value of the assets contributed or distributed (as of the date or dates of the contribution or distribution), multiplied by a fraction, the numerator of which is the number of days from the contribution or distribution to the end of the calendar year and the denominator of which is the days in the calendar year. Further, the beginning year values for the adjustment year and the trust year immediately preceding the adjustment year (unless the adjustment year is the first year of the trusts) shall be increased by the amount of such addition, or decreased by the amount of such distribution, for purposes of determining the unitrust amount for the year following the adjustment year.

E. Computing Fair Market Value. All computations of each trusts’ fair market value, or the value of any contributions or distributions as set forth above, shall include accounting income and principal, but no accrual shall be required. If the trusts include assets for which there is not a ready market, the trustees shall adopt such method of valuation as they deem reasonable in their discretion under the circumstances. **[See notes to Basic form concerning closely-held businesses or illiquid assets]**

F. Distribute all Income in Marital TRU. If in any trust year the net income earned in the Marital TRU exceeds the unitrust amount to be paid from the Marital TRU, such excess net income shall be distributed to my said \_\_\_\_\_ at least annually.

G. Income Earned in Estate Prior to Trust Funding.

In addition to the unitrust amount as determined above for the Marital TRU and the Credit Shelter TRU, the income earned from the assets held in my estate and distributed to my trustees hereunder, prior to the complete funding of each trust, shall be distributed to my said\_\_\_\_\_.

H. Source of Unitrust Amounts. The unitrust amount shall be paid from net accounting income, then from any other ordinary income, then from net realized short term capital gains, next from net realized long term capital gains, and finally, from the principal of the trusts. This ordering rule shall be applied to the Marital TRU only, if the Marital TRU is in existence, and if not, then the unitrust amount shall be paid in the above order from the Credit Shelter TRU.

I. Discretionary Distributions of Additional Amounts. In addition to the unitrust amount as set forth above, my trustees shall distribute such additional amounts, if any, of income or principal to my said \_\_\_\_\_ as the trustees deem advisable for h\_\_ health, maintenance, and support in h\_\_ accustomed manner of living, taking into account other assets and income otherwise available to h\_\_, provided, further, that my trustees shall first utilize the trust assets of the Marital TRU prior to distributing any such sums from the Credit Shelter TRU. The source of discretionary distributions of additional amounts shall be as set forth in H. above for the unitrust amount.

**Form 7 - Three TRU GST Plan--Exempt and Nonexempt Marital TRU and Credit Shelter TRU—Ordered Unitrust Plan.**

(3) Exempt Marital, Nonexempt Marital and Credit Shelter TRU's. During the lifetime of my \_\_\_\_\_, \_\_\_\_\_, my trustees shall administer the Exempt Marital TRU, the Nonexempt Marital TRU and the Credit Shelter TRU as Total Return Unitrusts. Except as indicated below, the terms of all three trusts shall be the same.

(a) During \_\_\_\_\_'s Life. My trustees shall pay the unitrust amount set forth below to or for the benefit of my \_\_\_\_\_, during h\_\_\_\_\_ life, in quarter-annual installments.

(b) Unitrust Amount. The trustees shall pay to my \_\_\_\_\_ in each year of these trusts ("trust year") during h\_\_\_\_\_ life a unitrust amount equal to \_\_\_\_\_(\_\_\_\_ percent) percent of the average of the combined fair market values of the Exempt Marital TRU, the Nonexempt Marital TRU and the Credit Shelter TRU as of the close of the first business day of the trust year (or the date of first funding for the first trust year) and the two previous trust years (or such lesser number of trust years as are available for the first two years of the trust). In the case of a short trust year, the distribution shall be calculated as set forth in subparagraph (c) below. In the case of contributions to or distributions from the trust, the unitrust amount shall be determined as set forth in subparagraph (d) below; provided, however, that the entire unitrust amount shall be paid first from the Nonexempt Marital TRU and nothing shall be paid from the Credit Shelter TRU unless or until the Nonexempt Marital TRU and the Exempt Marital TRU have been exhausted. If the Nonexempt Marital TRU is depleted, the entire unitrust amount shall first be paid from the Exempt Marital TRU and nothing shall be paid from the Credit Shelter TRU unless or until the Exempt Marital TRU is exhausted. If there is no Nonexempt Marital TRU nor an Exempt Marital TRU, then the entire unitrust amount shall first be paid from the Credit Shelter TRU. If in any trust year, the net income earned in the Nonexempt Marital TRU

or the Exempt Marital TRU exceeds the unitrust amount payable from each such trust, such excess net income shall be distributed to my \_\_\_\_\_ at least annually. **[Last sentence required for non-unitrust states and may be preferable in three trust plan even in unitrust states, because the Exempt Marital TRU must separately qualify for the marital deduction, and the Proposed Regulations indicate only that a three-five percent range is acceptable. As a result, to be sure of qualifying for the Marital Deduction, the Exempt Marital TRU may separately require a payout of either the “income” or a three percent TRU distribution. Since three percent is likely to be more than the accounting income, paying out the “income” from the Exempt Marital Trust as a “bonus” may be the least complicated drafting alternative. Subtracting the “income” paid from the Exempt Marital TRU from the unitrust amount to be paid from the Nonexempt Marital TRU would also qualify but is confusing, especially since this would mean that at the beginning of the trust year you couldn’t say how much the unitrust amount would be (since you don’t know in advance what the “income” from the Exempt Marital Trust will be!). The GST Exemption and the Applicable Credit Amount are scheduled to merge in 2004, so this may have decreased importance going forward. However, there may well be instances where the client has used part or all of her applicable credit amount to make gifts to children, leaving more GST Exemption than Applicable Credit Amount available. Hence drafting attention must still be given to the qualification of the “exempt” marital for the marital deduction. Because of the potentially huge change in the size of the Credit Shelter TRU under EGTRRA, this approach will give greater certainty to the distributions for the surviving spouse than drafting for example a five percent Nonexempt Marital TRU, a three percent Exempt Marital TRU and a Fully Discretionary Credit Shelter Trust.]**

(d) Short year. For a short tax year, the unitrust amount for each trust shall be based upon a prorated portion of the unitrust amount set forth above comparing the number of days in the short tax year to the number of days in the calendar year of which the short tax year is a part.

(e) Contributions and Distributions. In any year in which assets are added to or distributed from the trusts (other than the unitrust amount and the initial funding of the trust) (hereinafter “adjustment year”), the unitrust amount shall be increased (in the case of a contribution) or decreased (in the case of a distribution) by an amount equal to \_\_\_\_ (\_\_\_\_ percent) percent **[insert unitrust rate]** times the fair market value of the assets contributed or distributed (as of the date or dates of the contribution or distribution), multiplied by a fraction, the numerator of which is the number of days from the contribution or distribution to the end of the calendar year and the denominator of which is the days in the calendar year. Further, the first business day fair market values for the adjustment year and the year immediately preceding the adjustment year (unless the adjustment year is the first year of the trust) shall be increased by the amount of such addition, or decreased by the amount of such distribution, for purposes of determining the unitrust amount for years following the adjustment year. **[This complicated language is needed to accommodate multi-year funding of the trust from estates or other sources and discretionary distributions, in light of the three-year smoothing rule.]**

(f) Computing fair market value. All computations of each trust’s fair market value, or the value of any contributions or distributions as set forth above, shall include accounting income and principal, but no accruals shall be required. If the trusts include assets for which there is not a ready market, the trustees shall adopt such method of valuation as they deem reasonable in their sole discretion under the circumstances. **[This allows a closely-held business interest or real estate to be placed in the trust, but the Total Return Unitrust is less effective for this type of asset, and may well be problematic if this type of asset is a major portion of the trust.]**

(g) Income earned in estate prior to trust funding. In addition to the unitrust amount as determined above, the net accounting income earned in my estate and allocable to the Marital Exempt TRU and the Marital Non-Exempt TRU shall be paid to that trust, and distributed to my \_\_\_\_\_ in addition to the unitrust amount set forth above.

(h) Source of unitrust and discretionary distributions.

The unitrust amount shall be paid from net accounting income. If the net accounting income is insufficient to satisfy the unitrust amount, the trustees shall pay the unitrust amount from any other ordinary income in the trust, and to the extent insufficient, the trustees shall pay any net realized short term capital gains as are needed to satisfy the unitrust amount. If the foregoing amounts are still insufficient, the trustees shall pay the unitrust amount from such net realized long term capital gains as are needed to satisfy the unitrust amount, and if still insufficient, the balance needed shall be paid from the principal of the trust. This ordering rule is intended to be applied only to the trust from which the unitrust amount is paid, provided that, to the extent that discretionary distributions are made from any trust hereunder, this same ordering rule shall apply with reference to such discretionary distributions. **[If your state has a statutory unitrust with the foregoing ordering rule, it is clear under Prop. Reg. § 1.643(b) and Prop. Reg. § 1.643(e), Example 9, that the ordering rule will be respected. It is likely that if the foregoing ordering rule is in the governing instrument, rather than being a default provision in your state law, that it will also be respected, provided that the ordering rule is not inconsistent with your state law. If this were not the case, computer modeling suggests that the payout rate should be lowered .25% to .35% to have a roughly equivalent possibility of preserving the value of the trust after the effect of taxes, expenses and inflation, assuming the trust has a portfolio with a current or stepped up cost basis, and perhaps twice that amount, or .50% to .70% for a trust with an extremely low cost basis portfolio.]**

(i) Discretionary distributions of additional amounts.

In addition to the unitrust amount as set forth above, my trustees shall distribute such additional amounts, if any, of accounting income, other ordinary income, capital gain or principal to my said \_\_\_\_\_ as the corporate trustee, acting alone, deems advisable for h\_\_ health, maintenance, and support in h\_\_ accustomed manner of living, and specifically including educational expenses \_\_\_ may incur either for h\_\_self or our issue, and taking into account other assets and income otherwise available to h\_\_ and such issue. Provided, however, it is my direction that such additional distributions be made from my Non-Exempt Marital TRU to the extent possible prior to the distributions of such

additional discretionary distributions from the Exempt Marital TRU, and that such additional distributions be made from my Exempt Marital TRU to the extent possible prior to any such distributions from the Credit Shelter TRU.

(j) Goals of trusts. My goals concerning these trusts include the provision of a relatively smooth flow of distributions to my \_\_\_\_\_, which distributions over the anticipated term of the trusts may maintain to the extent practicable their real spending power after inflation. A second and related goal is to maintain the real spending power of the trust corpus both for the long term benefit of my \_\_\_\_\_ and also for the benefit of my children and grandchildren. It is my intent by using total return unitrusts which do not distinguish in investment goal between the production of accounting income and short and long term capital gains, to eliminate any conflict the trustees might otherwise experience between attaining the two goals set forth above. I have set an overall unitrust rate of \_\_\_\_\_ (\_\_\_\_\_ percent) percent for the trusts based upon my expectation of the financial needs of my spouse if he survives me. Since I have directed that both unitrust and discretionary distributions be made to the extent possible first from Nonexempt Marital TRU, then the Exempt Marital TRU and lastly the Credit Shelter TRU, I understand that growth will be most achievable in the Credit Shelter TRU; to a lesser extent in the Exempt Marital TRU and least achievable in the Nonexempt Marital TRU. I further recognize that the goal of maintaining the overall real value of the trusts will not be attainable every year, and may not be even over the long term, even if my trustees act with appropriate skill, care and caution. I further understand that to the extent discretionary distributions are made in addition to the unitrust amount that these economic goals may be compromised. Nevertheless, the corporate trustee shall not be liable for its good faith exercise of judgment in distributing such funds.

**[Select whichever option reflects best the settlor's intent:**

**Option 1: The corporate trustee may wish to take into account that my primary goal is to benefit my \_\_\_\_\_ during h\_\_\_\_ lifetime and that the buildup of funds for the next generation is of secondary importance. OR**

**Option 2: The corporate trustee may wish to take into account that my intent is to provide a permanent and increasing source of funds for the lifetime of my \_\_\_\_\_ and that the buildup of value to be passed forward into the next generations is of considerable importance.]**

(4) Payments on \_\_\_\_\_'s Death. On the death of my \_\_\_\_\_, the trustees shall pay any accrued or undistributed distribution amount and, if applicable, excess net income from the Exempt Marital TRU and the Nonexempt Marital TRU to my said \_\_\_\_\_'s estate. The trustees shall pay to my \_\_\_\_\_'s executor or directly to the taxing authority from the Nonexempt Marital TRU such amount, if any, as my \_\_\_\_\_'s executor certifies to be the additional death taxes resulting from the inclusion of the Exempt Marital TRU and the Nonexempt Marital TRU in my \_\_\_\_\_'s estate for death tax purposes. If there is no Nonexempt Marital TRU, such taxes shall be paid from the Exempt Marital TRU.

(5) Distribution of Exempt and Nonexempt Marital TRU's After \_\_\_\_\_'s Death. After the payments described in (4) above are made subsequent to my \_\_\_\_\_'s death, the remaining Exempt and Nonexempt Marital TRU and the Credit Shelter TRU shall be distributed to such of the members of the class consisting of my issue, in such shares and subject to such trusts and conditions as my \_\_\_\_\_ shall appoint and direct in h\_\_\_\_ will by specific reference hereto and specific reference to the Exempt Marital TRU, the Nonexempt Marital TRU, the Credit Shelter TRU or all of the TRU's. Any unappointed amount shall be held, administered and distributed as set forth in paragraph 3. below, for provisions following \_\_\_\_\_'s death or if \_\_\_\_\_ predeceases.

(6) Right to Disclaim. If my \_\_\_\_\_ disclaims h\_\_\_\_ interest in any portion of the trust shares created hereunder, such portion shall pass to my living issue, per stirpes. If my \_\_\_\_\_ dies before accepting any benefits, h\_\_\_\_ personal representative shall have the right to disclaim h\_\_\_\_ interest in all or a portion of the trusts created hereunder.

