

Articles

Statutory Techniques for Balancing the Financial Interests of Trust Beneficiaries

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There are few sorrows, however poignant, in which a good income is of no avail.

Logan Pearsall Smith (1865–1946)¹

TRUSTEES HAVE LONG struggled with the duty to balance the interests of current and future beneficiaries of a trust. As modern portfolio investment techniques and laws encourage trustees to invest for total return, trust legislation has developed that empowers trustees to mitigate the inequitable effects to beneficiaries of this investment approach. Key legislation includes the Uniform Principal and Income Act,² unitrust statutes, the Uniform Management of Institutional Funds Act,³ and private foundation tax compliance statutes. This Article explains why these acts are important in the context of current investment practices and laws, details the different approaches, and compares them. It concludes by suggesting a broadening of the application of these laws, including the extension of the Uniform Management of Institutional Funds Act to non-institutional trustees.

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1. ROBERT ANDREWS, *THE CONCISE COLUMBIA DICTIONARY OF QUOTATIONS* 174 (1989).

2. *See* UNIF. PRINCIPAL & INCOME ACT, 7B U.L.A. 131–92 (1997).

3. *See* UNIF. MGMT. INSTITUTIONAL FUNDS ACT, Part II, 7A U.L.A. 475–509 (1976).

Introduction

Sharing is hard. In a trust, the current and future interest holders must share the risk and return of the investments of the trust, and the parties may disagree vigorously about what investment and fiduciary policies are in their own individual best interests. The delicate role of the trustee is to balance these interests, administering the trust fairly and in accordance with the terms of the trust and applicable fiduciary law.

Fiduciary law is gradually evolving to allow trustees to invest and manage trust funds in ways that allow them to balance these competing interests more efficiently. The widespread passage of the Uniform Prudent Investor Act⁴ and the acceptance of its underlying precepts of modern portfolio theory have encouraged trustees to invest trust assets with a goal of maximizing total return—the optimal amount of gain for the trust given its risk/reward tolerance, regardless of whether the gain is classified for trust accounting purposes as income or principal. Although this investment approach may maximize the financial success of the trust as a whole, it exacerbates the conflict between the income beneficiaries and the remaindermen, who have strong preferences about whether the character of the receipt from the investment lands in the “income” account or the “principal” account.

The conflict between the present and future interests is serious, and the trustee has a duty to appropriately balance these inherently competing interests. As section 183 of the *Restatement (Second) of Trusts* succinctly provides, “When there are two or more beneficiaries of a trust, the trustee is under a duty to deal impartially with them.”⁵ A trustee must struggle to structure the trust’s investments to balance the investment desires of the current and future beneficiaries.⁶

Adhering to the duty of impartiality is no simple task. While conforming to the fundamental fiduciary duty of impartiality, the trustee must also conform to a general standard of prudent investment.⁷ Section 227 of the *Restatement (Third) of Trusts* dictates that “[t]he trustee is under a duty to the beneficiaries to invest and manage the funds of the trust as a prudent investor would, in light of the purposes, terms, distribution

4. UNIF. PRUDENT INVESTOR ACT, 7B U.L.A. 281 (1994).

5. RESTATEMENT (SECOND) OF TRUSTS § 183 (1959). Restatements are produced and approved by the American Law Institute and are intended to state the common law of the United States on particular fields of law. Edward C. Halbach, Jr., *Uniform Acts, Restatements and Trends in American Trust Law at Century's End*, 88 CAL. L. REV. 1877, 1881 (2000).

6. See GEORGE T. BOGERT, TRUSTS 387–88 (6th ed. 1987); Jeffrey A. Zaluda, *Dealing with Controversy: A Trustee's Investment Dilemma*, 44 TAX MGMT. MEMO. 155 (May 5, 2003).

7. See RESTATEMENT (THIRD) OF TRUSTS § 227 (1992).

requirements, and other circumstances of the trust.”⁸ The comments to section 227 of the Restatement note that the interests of a life income beneficiary “are almost inherently in competition with those of the remainder beneficiaries These conflicting fiduciary obligations result in a necessarily flexible and somewhat indefinite duty of impartiality. The duty requires the trustee to balance the competing interests of differently situated beneficiaries in a fair and reasonable manner.”⁹

Being “fair and reasonable” is challenging when one beneficiary is clamoring for investments producing interest, rents, dividends, and other traditional trust accounting income and the remaindermen are arguing for growth investments. Balancing these desires has become even more intricate in recent years because the income yield from stocks and bonds has plummeted dramatically over the past two decades—perhaps as much as seventy percent.¹⁰

The need to produce returns that fall neatly and fairly into the categories of trust accounting income and principal is extremely challenging when faced with the requirements of the Uniform Prudent Investor Act and the concept of total return investing. Traditional income-only trusts are often simply incompatible with efficient investing. As noted by commentators Patrick Collins and Josh Stampfli, “[T]raditional trust structures force an extreme and unproductive conservatism on trustees, the result of which is either a slow erosion of purchasing power for current beneficiaries or a staggering opportunity cost for remaindermen.”¹¹

Fortunately, state legislatures around the country are taking action to enhance a trustee’s ability to administer an income-only trust in accordance with the realities of modern investment. Most states allow trustees at least one statutory method by which they can attempt to balance the interests of the current and future beneficiaries, and many states offer several approaches.¹² These approaches include the power to adjust under the Uniform Principal and Income Act, unitrust statutes, the Uniform

8. *Id.*

9. *Id.* at cmt. c.

10. See Terry L. Turnipseed, *Tools for Better Balancing the Interests of Income Beneficiaries and Remaindermen*, 28 TAX MGMT. EST., GIFTS & TR. J. 244, 244 (2003). For an additional discussion of the change in bond yields over the past few decades and their implications for total return trusts, see Lyman W. Welch, *Brave New World of Total Return Laws*, 141 TR. & EST. 24 (2002). The current S&P 500 average dividend yield is only about 1.9%, well below the historic average of 4% since 1936. See Jonathan Fuerbringer, *Companies with Cash Hoards Don't Necessarily Pay It Out*, N.Y. TIMES, July 22, 2004, at C1.

11. Patrick J. Collins & Josh Stampfli, *Promises and Pitfalls of Total Return Trusts*, 27 ACTEC J. 205 (2001).

12. See *infra* apps. A–C.

Management of Institutional Funds Act, state statutes authorizing private foundation trustees to distribute principal to meet Internal Revenue Code minimum distribution requirements, and a unique state-specific approach: section 8113 of the Pennsylvania Statutes.

This Article reviews the status of a trustee's investment guidelines under the Uniform Prudent Investor Act and related investment theories. It then discusses each of the major legislative techniques available to a trustee for balancing the interests of present and future beneficiaries when investing for total return. It compares these approaches, using a hypothetical example, to show the effects of the various techniques. Finally, it draws conclusions from the synthesis of this information and suggests the broadening of available techniques for the future.

I. The Evolution of the Prudent Investor

The investment standards applied to trustees have changed with the times. The trustee, who was once expected to behave as a "prudent man," is now referred to as a "prudent investor."¹³ This shift involves more than terminology as the focus on legal lists and secure investments has given way to modern concepts of investing.¹⁴ Modern investment techniques are the inspiration for and the reason behind statutes allowing trustees flexibility in balancing the interests of current and future beneficiaries. This section explains the development of investment standards and the tension they create for trustees.

A. The Prudent Man Rule

In the nineteenth century, trustees were first held to a "prudent man rule" standard of investment, which became the majority rule in the 1940s. The prudent man rule was formulated in 1830 by the Massachusetts Supreme Judicial Court in *Harvard College v. Amory*.¹⁵ In *Amory*, the trustees were sued by the charitable remainder beneficiaries for failing to protect the capital by investing in manufacturing and insurance stocks.¹⁶ In dicta, the court laid out the oft-quoted prudent man rule:

All that can be required of a trustee to invest, is, that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs,

13. Compare RESTATEMENT (SECOND) OF TRUSTS § 227 (1959), with RESTATEMENT (THIRD) OF TRUSTS § 227 (1992), and UNIF. PRUDENT INVESTOR ACT § 1, 7B U.L.A. 286 (1994).

14. See UNIF. PRUDENT INVESTOR ACT prefatory note, 7B U.L.A. 281 (1994).

15. 26 Mass. 446, 461 (1830).

16. *Id.* at 459-60.

not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested.¹⁷

Even in the early years of its application, courts recognized that the definition of a prudent man may change over time.¹⁸ In the 1919 case of *Kimball v. Whitney*, the Massachusetts Supreme Judicial Court reaffirmed the rule and expanded upon it as follows:

Good faith and sound discretion, as these terms ought to be understood by reasonable men of good judgment, were thus made the standard by which the conduct of trustees is to be measured. That is a comprehensive principle. It is wide in its scope. It is not limited to a particular time or a special neighborhood. It is general and inclusive, so that while remaining fixed, it may continue to be a safeguard under new financial institutions and business customs, changed commercial methods and practices, altered monetary usages and investment combinations. It avoids the inflexibility of definite classification of securities, it disregards the optimism of the promoter, and eschews the exuberance of the speculator. It holds fast to common sense and depends on practical experience. It is susceptible of being adapted to whatever conditions may arise in the evolution of society and the progress of civilization.¹⁹

The prudent man rule was widely accepted in the United States.²⁰ It was eventually adopted in the *Restatement (Second) of Trusts*, published in 1959.²¹ Section 227 of the *Restatement (Second) of Trusts* provides that the trustee's duty is "to make such investments and only such investments as a prudent man would make of his own property having in view the preservation of the estate and the amount and regularity of the income to be derived."²² This was a default rule that could be preempted by either a trust instrument or statute.²³ Although the *Restatement (Second) of Trusts* includes a duty to diversify, the prudence of each investment was to be determined individually.²⁴ Essentially, this standard "requires diversification, but only among unspeculative investments because none other is permitted."²⁵

17. *Id.* at 461.

18. *See* *Kimball v. Whitney*, 123 N.E. 665, 666 (Mass. 1919).

19. *Id.*

20. *See* 3 AUSTIN WAKEMAN SCOTT & WILLIAM FRANKLIN FRATCHER, *THE LAW OF TRUSTS* § 227.5 (4th ed. 1988); *RESTATEMENT (SECOND) OF TRUSTS* § 227 cmt. p (1959).

21. *RESTATEMENT (SECOND) OF TRUSTS* § 227 (1959).

22. *Id.*

23. *See id.*

24. *Id.* §§ 227 cmt. o & 228.

25. Paul G. Haskell, *The Prudent Person Rule For Trustee Investment and Modern Portfolio Theory*, 69 N.C. L. REV. 87, 94 (1990).

The case of *Chase v. Pevear*²⁶ is an example of a typical application of the *Restatement (Second) of Trusts* version of the prudent man rule.²⁷ In this case, the beneficiaries of a testamentary trust questioned various investments made by the trustee.²⁸ The Massachusetts Supreme Judicial Court restated the prudent man rule from *Harvard College v. Amory* and noted that it would not classify particular categories of investments as imprudent.²⁹ According to the court, “The trustee must exercise prudence in making or retaining each investment”³⁰ The court went on to examine seven different investments to determine whether or not each one was speculative, without any reference to its role in the overall portfolio.³¹ The court did recognize the need to diversify trust funds, but only to avoid over-investing in a single type of stock or bond.³²

As anticipated by the Massachusetts court in *Kimball v. Whitney*, the standard for trustees had to change with the times.³³ The old rule was criticized as outdated and overly conservative.³⁴ The time had come for a reform, or as some would argue, a return to the more flexible standard envisioned by the court in *Harvard College v. Amory* as opposed to “specific rules derived from specific cases.”³⁵

B. Contemporary Investment Theories

Changes in investment theory have shaped the evolution of standards of modern investment, leading to the current prudent investor rule.³⁶ Two of the key underpinnings of contemporary investment practices are modern portfolio theory and total return investing.³⁷ Each of these concepts has

26. 419 N.E.2d 1358 (Mass. 1981).

27. *See id.* at 1365.

28. *See id.* at 1362.

29. *See id.* at 1365; *Amory*, 26 Mass. at 461.

30. *Chase*, 419 N.E.2d at 1366.

31. *See id.* at 1366–69.

32. *See id.* at 1366.

33. *See Kimball v. Whitney*, 123 N.E. 665, 666 (Mass. 1919).

34. *See* Jeffrey N. Gordon, *The Puzzling Persistence of the Constrained Prudent Man Rule*, 62 N.Y.U. L. REV. 52, 61 (1987); Harvey E. Bines, *Modern Portfolio Theory and Investment Management Law: Refinement of Legal Doctrine*, 76 COLUM. L. REV. 721 (1976).

35. 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, 6 (1998).

36. *See* Robert B. Wolf, *Defeating the Duty to Disappoint Equally—The Total Return Trust*, 32 REAL PROP., PROB. & TR. 45, 52–53 (1997) [hereinafter Wolf, *Defeating the Duty*]; John H. Langbein, *The Uniform Prudent Investor Act and the Future of Trust Investing*, 81 IOWA L. REV. 641, 642 (1996).

37. *See* JONATHAN R. MACEY, AN INTRODUCTION TO MODERN FINANCIAL THEORY 17 (1998).

influenced the current law on appropriate trust investments, which in turn has influenced the development of statutory fiduciary powers that enable trustees to administer trusts fairly under these modern investment concepts. This section provides a summary of modern portfolio theory and total return investing.³⁸

The foundation of modern portfolio theory rests on two basic principles: (1) higher risk should result in a higher rate of return and (2) capital markets are basically efficient.³⁹ The first principle dictates that an investor should examine risk and return in light of the overall portfolio.⁴⁰ Risk is classified as either market risk or nonmarket risk.⁴¹ Market risk is the risk of lower return that affects all securities and is dictated by economic and political conditions.⁴² Generally, greater market risk correlates with greater return.⁴³ Nonmarket risk is the risk that a particular asset or industry will not perform as well as anticipated.⁴⁴ An example of nonmarket risk is a particular company's stock plummeting after the departure of key members of its board of directors. Since this event would not affect the market as a whole, the best protection against this risk is diversification.⁴⁵ Thus, according to modern portfolio theory, "the gains in one investment will cancel out the losses in another."⁴⁶ In contrast to the standard set forth in the prudent man rule of the *Restatement (Second) of Trusts*, modern portfolio theory permits investment in a speculative stock that is part of a diversified portfolio.⁴⁷

The second concept behind modern portfolio theory is that capital markets are basically efficient.⁴⁸ Importantly, this assertion leads to the conclusion that an individual investor selecting a portfolio should not be

38. A thorough examination of these concepts is beyond the scope of this Article. For more detailed information, the reader should consult the following authorities: JONATHAN R. MACEY, AN INTRODUCTION TO MODERN FINANCIAL THEORY (1998); BEVIS LONGSTRETH, MODERN INVESTMENT MANAGEMENT AND THE PRUDENT MAN RULE (1986); BURTON G. MALKIEL, A RANDOM WALK DOWN WALL STREET (5th ed. 1990).

39. See Horn, *supra* note 35, at 12.

40. See MACEY, *supra* note 37, at 17.

41. See *id.* at 20–21.

42. See *id.* at 23; Martin D. Begleiter, *Does the Prudent Investor Need the Uniform Prudent Investor Act—An Empirical Study of Trust Investment Practices*, 51 ME. L. REV. 28, 33–34 (1999).

43. See MACEY, *supra* note 37, at 23.

44. See *id.* at 22. This category also includes risks to particular industries that may include more than one company. *Id.*

45. See *id.* at 23.

46. See *id.* at 21–22.

47. See Haskell, *supra* note 25, at 103.

48. See MACEY, *supra* note 37, at 37–38.

able to achieve a greater return than the market in general.⁴⁹ The rationale is that the cost of each security reflects all of the public information about that security.⁵⁰ Since no individual can consistently predict future performance before the market adjusts, it is impossible to outperform the market.⁵¹ Therefore, modern portfolio theory not only permits passive investments (such as index funds), but it actually questions the use of more costly active management, which may be unable to achieve greater returns.⁵²

In addition to modern portfolio theory, a key component of current investment philosophy is total return investing. Total return investing means that assets are invested for maximum overall return, without regard to income and principal.⁵³ Economic changes over the last century spurred the development of the total return approach to investing.⁵⁴ At the time the prudent man rule was developing, trustees were concerned with preserving capital and “were inclined to emphasize long-term government and corporate bonds as the characteristic trust investment.”⁵⁵ Post-World War II inflation resulted in losses in bond values and trustees responded by slowly adding equity investments.⁵⁶ Inflation rates began to fluctuate significantly after the late 1960s, and the total return concept began to flourish as trustees realized that to sustain the actual value of the trust principal, the trust needed to grow at the inflation rate.⁵⁷

C. The Prudent Investor Rule

The 1990s marked a major change to the now-titled “prudent investor rule” with the publication of the *Restatement (Third) of Trusts* and the Uniform Prudent Investor Act (“UPIA”).⁵⁸ These new versions represented

49. See *id.* at 38–43; Horn, *supra* note 35, at 16.

50. See Langbein, *supra* note 36, at 657.

51. See *id.* Langbein posits that this does not mean that professional investment managers are “incompetent bunglers, indeed, just the opposite. They are so good at what they do that they effectively cancel each other out.” *Id.*

52. See Haskell, *supra* note 25, at 94. Haskell notes that passive investment is not permitted under the Restatement (Second) of Trusts section 227. *Id.* But see John H. Langbein & Richard A. Posner, *Market Funds and Trust-Investment Law*, 1976 AM. B. FOUND. RES. J. 1 (1976); John H. Langbein & Richard A. Posner, *Market Funds and Trust-Investment Law: II*, 1977 AM. B. FOUND. RES. J. 1 (1977).

53. See *id.*

54. See Wolf, *Defeating the Duty*, *supra* note 36, at 53.

55. Langbein, *supra* note 36, at 645.

56. See *id.*

57. Wolf, *Defeating the Duty*, *supra* note 36, at 53.

58. See RESTATEMENT (THIRD) OF TRUSTS § 227 (1992); UNIF. PRUDENT INVESTOR ACT, 7B U.L.A. 18 (Supp. 1997).

a significant change in the way the old standard of prudence was applied in practice and incorporated the more modern approaches of modern portfolio theory and total return investing.⁵⁹

In 1990, a revised “prudent investor rule” was adopted by the American Law Institute as part of the *Restatement (Third) of Trusts*.⁶⁰ Section 227 of the *Restatement (Third) of Trusts* requires a trustee to use “reasonable care, skill and caution” with respect to the trust portfolio as a whole, in contrast to the prior Restatement’s focus on individual investments.⁶¹ The trustee’s duty to diversify is now considered “fundamental.”⁶² Additionally, the standard established by the *Restatement (Third) of Trusts* only applies in the absence of direction from the trust instrument or a controlling statute.⁶³ A majority of states have adopted statutes based on the UPIA, and these statutes take precedence over the *Restatement (Third) of Trusts*.⁶⁴

The National Conference of Commissioners on Uniform State Laws issued the Uniform Prudent Investor Act in 1994.⁶⁵ As of 2004, some version of the UPIA has been enacted in thirty-nine states and the District

59. See Wolf, *Defeating the Duty*, *supra* note 36, at 63–66. One commentator has suggested that the version of the rule adopted in the Restatement (Third) of Trusts was too liberal and that it disregards the goals of private trusts. See Haskell, *supra* note 25, at 110–11.

60. RESTATEMENT (THIRD) OF TRUSTS § 227 (1992).

61. Compare RESTATEMENT (SECOND) OF TRUSTS § 227 (1959), with RESTATEMENT (THIRD) OF TRUSTS § 227 (1992). The new rule provides as follows:

§ 227. General Standard of Prudent Investment

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

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

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

(c) In addition, the trustee must:

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

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

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

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

RESTATEMENT (THIRD) OF TRUSTS § 227 (1992).

62. *Id.* § 227, cmt. f(3).

63. See *id.* § 228.

64. UNIF. PRUDENT INVESTOR ACT § 1, 7B U.L.A. 280 (2000 & Supp. 2004).

65. *Id.*

of Columbia.⁶⁶ The prefatory note to the UPIA acknowledges the influence of modern portfolio theory and the *Restatement (Third) of Trusts*.⁶⁷ This note highlights five “fundamental alterations” to the rule: (1) the prudence of an investment is evaluated as part of the total portfolio; (2) a trustee’s “central consideration” is the trade-off of risk and return; (3) there is no list of categories of investments that are prohibited; (4) a prudent investor is required to diversify; and (5) trustees are now permitted to delegate investment and management functions.⁶⁸ Section 1 of the UPIA establishes the scope of the rule by stating that its provisions are only default rules and that the terms of the trust instrument control.⁶⁹

The essence of the UPIA lies in section 2, which sets out the prudent investor standard.⁷⁰ Section 2(a) directs that “[a] trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable, care, skill and caution.”⁷¹ Section 2(b) incorporates modern portfolio theory by

66. *See id.*

67. *See id.* at prefatory note.

68. *Id.*

69. *Id.* § 1, at 286.

70. *Id.* § 2, at 289–90.

71. *Id.* The full text of section 2 reads as follows:

(a) A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable, care, skill and caution.

(b) A trustee’s investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust.

(c) Among circumstances that a trustee shall consider in investing and managing trust assets are such of the following as are relevant to the trust or its beneficiaries:

(1) general economic conditions;

(2) the possible effect of inflation or deflation;

(3) the expected tax consequences of investment decisions or strategies;

(4) the role that each investment or course of action plays within the overall trust portfolio, which may include financial assets, interests in closely held enterprises, tangible and intangible personal property, and real property;

(5) the expected total return from income and the appreciation of capital;

(6) other resources of the beneficiaries;

(7) needs for liquidity, regularity of income, and preservation or appreciation of capital; and

(8) an asset’s special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.

(d) A trustee shall make a reasonable effort to verify facts relevant to the investment and management of trust assets.

(e) A trustee may invest in any kind of property or type of investment consistent with the

stating that the standard applies to the risk and return of the overall portfolio and not to individual investments.⁷² The UPIA provides further guidance for trustees by including a list of circumstances that may be considered when making investments,⁷³ but the official commentary to the UPIA explains that this list is not meant to be exclusive.⁷⁴ The UPIA also emphasizes that no type of investment is automatically prohibited.⁷⁵ The commentary acknowledges that the character of investments changes over time and that it is “the trustee’s task to invest at a risk level that is suitable to the purposes of the trust.”⁷⁶

The duty to diversify is now a central requirement of prudent investing under section 3 of the UPIA.⁷⁷ The reason for diversifying is to reduce nonmarket risk, as described in modern portfolio theory.⁷⁸ The trustee is released from this duty if special circumstances outweigh the advantages of diversification.⁷⁹

The next several sections of the UPIA simply codify well-established rules applicable to trustees. Section 4 provides that a trustee shall take action necessary to conform the trust assets with the prudence standard “within a reasonable time.”⁸⁰ Sections 5 and 6 affirm the trustee’s duty of loyalty and duty of impartiality to the beneficiaries.⁸¹ Section 7 addresses the trustee’s obligation to avoid unreasonable costs.⁸² Read in the context of modern portfolio theory, this section suggests that trustees who actively manage the portfolio instead of investing in index funds may have to demonstrate an increase in value to the beneficiaries that is commensurate

standards of this [Act].

(f) A trustee who has special skills or expertise, or is named trustee in reliance upon the trustee’s representation that the trustee has special skills or expertise, has a duty to use those special skills or expertise.

Id.

72. *Id.* § 2(b), at 290.

73. *Id.* § 2(c), at 290.

74. *Id.* § 2 cmt., at 290.

75. *Id.* § 2(c), at 290.

76. *Id.* § 2 cmt., at 290.

77. *See id.* § 3, at 296 (“A trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying.”).

78. *See id.* § 3 cmt., at 297.

79. *See id.* at 296–97. The commentary provides examples of special circumstances such as a trust holding a block of low-cost basis securities or a retaining a family business. *Id.*

80. *Id.* § 4, at 298.

81. *Id.* §§ 5–6, at 299–300.

82. *Id.* § 7, at 301.

with the increase in cost.⁸³ Section 8 provides trustees with some comfort by stating that their actions will be evaluated “in light of the facts and circumstances existing at the time of the trustee’s decision or action and not by hindsight.”⁸⁴ There was no corollary to this section in the *Restatement (Second) of Trusts*.⁸⁵

Section 9 of the UPIA represents a major shift in prior law by authorizing a trustee to delegate investment and management duties.⁸⁶ The *Restatement (Second) of Trusts* prohibited trustees from delegating any duties that required the trustee to exercise discretion.⁸⁷ The commentary to the UPIA notes that more recent legislation has supported the right of a trustee to delegate some functions, but warns that the beneficiary must be protected against unreasonable delegation.⁸⁸ Section 9 “is designed to strike the appropriate balance between the advantages and the hazards of delegation” by imposing a duty of care on the trustee when choosing what and to whom to delegate.⁸⁹

Both the UPIA and the *Restatement (Third) of Trusts* impose upon the trustee a duty to invest prudently, consistent with current investment tenets, including modern portfolio theory and total return investing.⁹⁰ Gone is the duty to invest “as a prudent man . . . having in view the preservation of the estate and the amount and regularity of the income to be derived,” as well as the incentive to focus on the production of trust accounting income.⁹¹ Instead, trustees are empowered to invest more efficiently, more aggressively, and more diversely.

D. Can a Trustee Be Both Prudent and Impartial?

The rise of the prudent investor rule may have been a boon for trust beneficiaries in terms of encouraging efficient investment, but it exacerbated a tension between the interests of the current and future trust beneficiaries that a trustee is compelled to balance. Trustees are saddled with a duty of impartiality and must treat the future and income

83. See Horn, *supra* note 35, at 17.

84. UNIF. PRUDENT INVESTOR ACT § 8, 7B U.L.A. 302 (2000).

85. See RESTATEMENT (SECOND) OF TRUSTS §§ 227–29 (1959).

86. UNIF. PRUDENT INVESTOR ACT § 9, 7B U.L.A. 303 (2000).

87. RESTATEMENT (SECOND) OF TRUSTS § 171 (1959) (permitting delegation of “ministerial” duties only).

88. See UNIF. PRUDENT INVESTOR ACT § 9, 7B U.L.A. at 303 cmt.

89. *Id.*

90. See *id.* § 2, at 289; RESTATEMENT (THIRD) OF TRUSTS § 227 (1992).

91. See RESTATEMENT (SECOND) OF TRUSTS § 227(a) (1959).

beneficiaries fairly and equitably.⁹² Income beneficiaries, naturally, have a preference for investments producing trust accounting income, which will be applied for their benefit.⁹³ Remainder beneficiaries, just as naturally, favor investments that increase the value of the trust corpus.⁹⁴ Trustees must now treat these competing goals impartially, while “investing as a prudent investor would.”⁹⁵

In the current economic environment, it is more difficult than ever to meet the needs of the income beneficiaries while preserving the capital of the trust.⁹⁶ The average dividend yield for the Standard & Poor’s 500 was 1.83% in February 2005, compared to an average of 4% since 1936.⁹⁷ The ten-year government bond reached a forty-five year low of 3.11% in June 2003, and some analysts believe that yields could plunge even more.⁹⁸ When viewed as a long-term investment and compared to fixed income products, equity maintains its value in the face of inflation and has higher rates of return.⁹⁹ Equity gained an additional advantage with the enactment of the Jobs and Growth Tax Relief Act of 2003,¹⁰⁰ which reduced the maximum capital gains tax rate from 20% to 15%.¹⁰¹

These trends make it difficult for trustees to generate income as it is traditionally defined. As a result, a traditional approach to investment by trustees leads to lower overall returns.¹⁰² Total return investing recognizes that “return can come in many forms, including capital gain.”¹⁰³ This

92. See *id.* § 183.

93. See Barry L. Kohler, *Tru or False: An Introduction to the Total Return Unitrust*, 16 ME. B.J. 94, 95 (Spring 2001) (“Unfortunately, income beneficiaries measure trust performance by the amount of income received, and remaindermen measure performance by the appreciation of the value of the corpus (principal). Consequently, both are often disappointed . . .”).

94. *Id.*

95. See RESTATEMENT (THIRD) OF TRUSTS § 183 (1992); UNIF. PRUDENT INVESTOR ACT § 2(a), 7B U.L.A. 289 (1994).

96. See Wolf, *Defeating the Duty*, *supra* note 36 at 50–51; Joel C. Dobris, *New Forms of Private Trusts for the Twenty-First Century—Principal and Income*, 31 REAL PROP. PROB. & TR. J. 1, 3 (Spring 1996).

97. See Fuerbringer, *supra* note 10, at C7; *Markets Lineup*, WALL ST. J., February 1, 2005, at C2.

98. See Jennifer Ablan, *Current Yield: Déjà Vu All Over Again for Bonds*, BARRON’S, Mar. 15, 2004, at MW14. This benchmark was yielding 4.149% as of September 13, 2004. Aaron Lucchetti, *Indebted Consumers Reshape the Bond Market*, WALL ST. J., Sept. 14, 2004, at C1.

99. See Wolf, *Defeating the Duty*, *supra* note 36, at 53, 57–58.

100. Jobs and Growth Tax Relief Reconciliation Act of 2003, 26 U.S.C. § 1 (2004).

101. I.R.C. § 1(h)(1)(C) (2004), amended by Jobs and Growth Act § 301(a)(2)(A) (2003).

102. See Wolf, *Defeating the Duty*, *supra* note 36, at 51.

103. 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, 53 (1993).

school of thought rejects the practice of labeling return as either income or principal.¹⁰⁴ For trust beneficiaries, however, these labels are important because of their effect on distributions.

The responsibility of the trustee is to balance these competing duties to the full extent of its ability.¹⁰⁵ While this is challenging, recent developments in fiduciary law are making this task more manageable. The flexibility provided by these developments is critically needed by trustees who find themselves investing between a rock (prudent investment) and a hard place (impartial treatment of current and future interests).

II. Legislation Allowing Trust Distribution Flexibility

In the face of the realities of balancing modern investment techniques and beneficiary needs, state legislatures have enacted various statutes that allow trustees a more flexible approach to trusts that base payments on trust accounting income.¹⁰⁶ Although modern drafters can alleviate several of the problems caused by income-only trusts by drafting for principal invasion in some trusts, a significant number of existing trusts continue to be constrained by income-only provisions. The income-only provisions often cannot be eliminated, either because the trust is irrevocable or because the provisions are necessary to obtain certain tax benefits, leaving many trusts confined to these provisions and the lack of flexibility they entail.¹⁰⁷ In response, state legislatures have created an assortment of techniques that allow trustees to alter the amounts paid to income beneficiaries. While legislative approaches vary greatly in scope and applicability, all share the characteristic of supporting a trustee in observing the prudent investor rule and investing for total return.

Each legislative approach has its own strengths and weaknesses, and some are better suited for certain types of trusts. The following section explains the various approaches to balance the interests of current and future trust beneficiaries offered by state legislatures and explores the pros and cons of each technique. The five approaches that will be considered in

104. *See id.*

105. *See* RESTATEMENT (THIRD) OF TRUSTS § 227 cmt. c, at 13 (1992).

106. STATE BAR OF GEORGIA, FIDUCIARY LAW SECTION, REPORT OF THE FLEXIBLE INCOME TRUST COMMITTEE (July 10, 2002), available at http://www.gabar.org/fid_news.asp (last accessed Jan. 9, 2005), provides a thoughtful analysis of the role of the power to adjust and the unitrust option in the context of current prudent investment law.

107. For example, certain trusts for minors, marital deduction trusts, and qualified subchapter S trusts are required by tax law to distribute all of their income to the beneficiary. *See* I.R.C. § 2503(c) (2004) (minor's trusts); I.R.C. § 2056(b) (2004) (marital trusts); and I.R.C. § 1361(d)(3)(B) (2004) (qualified subchapter S trusts).

this section include (A) the power to adjust under the 1997 Uniform Principal and Income Act; (B) the ability to convert to a unitrust; (C) the appropriation of appreciation under the Uniform Management of Institutional Funds Act; (D) the authorization of distribution of principal from private foundation trusts to meet minimum distribution requirements of the Internal Revenue Code (called “private foundation tax compliance statutes”); and (E) an unusual state-specific approach: section 8113 of the Pennsylvania Statutes.

A. Power to Adjust Under the Uniform Principal and Income Act

Perhaps the most dramatic development in the past decade for trustees seeking to balance the financial interests of beneficiaries has been the power to adjust receipts and expenses between income and principal under the 1997 Uniform Principal and Income Act. The power to adjust applies to trusts that define payments to beneficiaries based on income. A version of the Uniform Principal and Income Act already has been enacted in a majority of states, and although this legislation is fairly recent, its impact is likely to be substantial.¹⁰⁸ The power to adjust is a key enabler of total return investment.¹⁰⁹

108. Appendix A to this Article also lists the states that have enacted the 1997 Principal and Income Act as stated in Uniform Laws Annotated, but given the Act’s continuing progress in many jurisdictions, print lists become outdated quickly. To determine whether a state has enacted the 1997 Uniform Principal and Income Act, visit the website of the National Conference of Commissioners on Uniform State Laws (“NCCUSL”) at <http://www.nccusl.org/Update/DesktopDefault.aspx?tabindex=3&tabid=60> (last accessed Sept. 22, 2004). The Leimberg website is also a helpful resource. See LEIMBERG & LECLAIR, INC., TRUS (TOTAL RETURN UNITRUSTS): JURISDICTIONS HAVING ENACTED UNIFORM PRINCIPAL AND INCOME ACT, at <http://www.leimberg.com/freeResources/truStates.asp#ma> (last accessed Sept. 22, 2004).

109. See UNIF. PRINCIPAL & INCOME ACT § 104, 7B U.L.A. 141 (2000). The comment to the Act provides insight on the contribution of the adjustment power to the trustee’s ability to manage a trustee impartially and productively, and provides as follows:

Impartiality and productivity of income. The duty of impartiality between income and remainder beneficiaries is linked to the trustee’s duty to make the portfolio productive of trust accounting income whenever the distribution requirements are expressed in terms of distributing the trust’s “income.” . . . Under the prudent investor rule, “[t]o whatever extent a requirement of income productivity exists . . . the requirement applies not investment by investment but to the portfolio as a whole.” . . . The power to adjust under Section 104(a) is also to be exercised by considering net income from the portfolio as a whole and not investment by investment. . . . While the purpose of the power to adjust in Section 104(a) is to eliminate the need for a trustee who operates under the prudent investor rule to be concerned about the income component of the portfolio’s total return, the trustee must still determine the extent to which a distribution must be made to an income beneficiary and the adequacy of the portfolio’s liquidity as a whole to make that distribution.

Section 104 of the 1997 Uniform Principal and Income Act grants trustees the ability to alter the amount paid to current beneficiaries by adjusting receipts and expenses between income and principal, alleviating the restraints of trust accounting definitions of income and principal.¹¹⁰ The Act provides:

A trustee may adjust between principal and income to the extent the trustee considers necessary if the trustee invests and manages trust assets as a prudent investor, the terms of the trust describe the amount that may or must be distributed to a beneficiary by referring to the trust's income, and the trustee determines, after applying the rules in Section 103(a), that the trustee is unable to comply with Section 103(b).¹¹¹

Id. at 144–45 cmt.

110. *Id.*

111. *Id.* § 104(a), at 141. The comment to the Act provides detail on these three prerequisites to exercising the power to adjust:

Three conditions to the exercise of the power to adjust. The first of the three conditions that must be met before a trustee can exercise the power to adjust—that the trustee invest and manage trust assets as a prudent investor—is expressed in this Act by language derived from the Uniform Prudent Investor Act, but the condition will be met whether the prudent investor rule applies because the Uniform Act or other prudent investor legislation has been enacted, the prudent investor rule has been approved by the courts, or the terms of the trust require it. Even if a State's legislature or courts have not formally adopted the rule, the Restatement establishes the prudent investor rule as an authoritative interpretation of the common law prudent man rule, referring to the prudent investor rule as a "modest reformulation of the Harvard College dictum and the basic rule of prior Restatements." Restatement of Trusts 3d: Prudent Investor Rule, Introduction, at 5. As a result, there is a basis for concluding that the first condition is satisfied in virtually all States except those in which a trustee is permitted to invest only in assets set forth in a statutory "legal list." The second condition will be met when the terms of the trust require all of the "income" to be distributed at regular intervals; or when the terms of the trust require a trustee to distribute all of the income, but permit the trustee to decide how much to distribute to each member of a class of beneficiaries; or when the terms of a trust provide that the beneficiary shall receive the greater of the trust accounting income and a fixed dollar amount (an annuity), or of trust accounting income and a fractional share of the value of the trust assets (a unitrust amount). If the trust authorizes the trustee in its discretion to distribute the trust's income to the beneficiary or to accumulate some or all of the income, the condition will be met because the terms of the trust do not permit the trustee to distribute more than the trust accounting income. To meet the third condition, the trustee must first meet the requirements of Section 103(a), i.e., she must apply the terms of the trust, decide whether to exercise the discretionary powers given to the trustee under the terms of the trust, and must apply the provisions of the Act if the terms of the trust do not contain a different provision or give the trustee discretion. Second, the trustee must determine the extent to which the terms of the trust clearly manifest an intention by the settlor that the trustee may or must favor one or more of the beneficiaries. To the extent that the terms of the trust do not require partiality, the trustee must conclude that she is unable to comply with the duty to administer the trust impartially. To the extent that the terms of the trust do require or permit the trustee to favor the income beneficiary or the remainder beneficiary, the trustee must conclude that she is unable to achieve the degree of partiality required or permitted. If the trustee comes to either conclusion—

For example, a trustee of a \$1,000,000 trust with a 2% (\$20,000) return on income-producing investments and a 7% (\$70,000) return on equity investments may exercise the power to adjust to make distributions in excess of trust accounting income by transferring a reasonable amount (say \$15,000) from principal to income. The trustee could then distribute to the income beneficiary the trust accounting income (\$20,000) plus the amount adjusted from principal (\$15,000), for a greater total distribution (\$35,000). When exercising its discretion, the trustee will be guided by any limits in the applicable state statute.

According to the Act's comment, the purpose of this power "is to enable a trustee to select investments using the standards of a prudent investor without having to realize a particular portion of the portfolio's total return in the form of traditional trust accounting income such as interest, dividends, and rents."¹¹²

Section 103(a) of the Uniform Principal and Income Act requires that a fiduciary: (1) shall administer a trust or estate in accordance with the terms of the trust or the will, even if there is a different provision in the Principal and Income Act; (2) may administer a trust or estate by the exercise of a discretionary power of administration given to the fiduciary by the terms of the trust or the will, even if the exercise of the power produces a outcome different from a result required or permitted by the Principal and Income Act; (3) shall administer a trust or estate in accordance with the Principal and Income Act if the terms of the trust or the will do not contain a different provision or do not give the fiduciary a discretionary power of administration; and (4) shall add a receipt or charge a disbursement to principal to the extent that the terms of the trust and the Principal and Income Act do not provide a rule for allocating the receipt or disbursement to or between principal and income.¹¹³ Section 103(b) requires that a fiduciary shall administer a trust or estate impartially, based on what is fair and reasonable to all of the beneficiaries.¹¹⁴ An exception to this requirement exists if the terms of the trust or the will clearly manifest an intention that the fiduciary shall or may favor one or more of the beneficiaries.¹¹⁵

that she is unable to administer the trust impartially or that she is unable to achieve the degree of partiality required or permitted—she may exercise the power to adjust under Section 104(a).

Id. at 144 cmt.

112. *Id.* § 104(a) cmt., at 143.

113. *See id.* § 103(a), at 139.

114. *See id.* § 103(b), at 140.

115. *See id.*

The Act sets forth several factors that a trustee should consider in deciding whether the power to adjust should be exercised, and if so, to what extent.¹¹⁶ The list is not exclusive, and a trustee is expected to consider all relevant facts and circumstances of the trust and its beneficiaries. These factors are consistent, to a large degree, with the factors a trustee should consider under the Uniform Prudent Investor Act.¹¹⁷

The Uniform Principal and Income Act also sets forth a series of circumstances under which a trustee is forbidden from making an adjustment.¹¹⁸ These prohibitions are generally intended to ward off

116. See *id.* § 104(b), at 142. These factors include (1) the nature, purpose, and expected duration of the trust; (2) the intent of the settlor; (3) the identity and circumstances of the beneficiaries; (4) the needs for liquidity, regularity of income, and preservation and appreciation of capital; (5) the assets held in the trust, including (a) the extent to which they consist of financial assets, interests in closely held enterprises, tangible and intangible personal property, or real property, (b) the extent to which an asset is used by a beneficiary, and (c) whether an asset was purchased by the trustee or received from the settlor; (6) the net amount allocated to income under the other sections of the Principal and Income Act and the increase or decrease in the value of the principal assets, which the trustee may estimate as to assets for which market values are not readily available; (7) whether and to what extent the terms of the trust give the trustee the power to invade principal or accumulate income or prohibit the trustee from invading principal or accumulating income, and the extent to which the trustee has exercised a power from time to time to invade principal or accumulate income; (8) the actual and anticipated effect of economic conditions on principal and income and effects of inflation and deflation; and (9) the anticipated tax consequences of an adjustment. *Id.*

117. The comment to section 104 of the Uniform Principal and Income Act includes the following statement:

Section 104(b) requires a trustee to consider factors relevant to the trust and its beneficiaries in deciding whether and to what extent the power to adjust should be exercised. Section 2(c) of the Uniform Prudent Investor Act sets forth circumstances that a trustee is to consider in investing and managing trust assets. The circumstances in Section 2(c) of the Uniform Prudent Investor Act are the source of the factors in paragraphs (3) through (6) and (8) of Section 104(b) (modified where necessary to adapt them to the purposes of this Act) so that, to the extent possible, comparable factors will apply to investment decisions and decisions involving the power to adjust. If a trustee who is operating under the prudent investor rule decides that the portfolio should be composed of financial assets whose total return will result primarily from capital appreciation rather than dividends, interest, and rents, the trustee can decide at the same time the extent to which an adjustment from principal to income may be necessary under Section 104. On the other hand, if a trustee decides that the risk and return objectives for the trust are best achieved by a portfolio whose total return includes interest and dividend income that is sufficient to provide the income beneficiary with the beneficial interest to which the beneficiary is entitled under the terms of the trust, the trustee can decide that it is unnecessary to exercise the power to adjust.

Id.

118. See *id.* § 104(c), at 142. The Act provides:

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

unwanted tax consequences. For instance, the Uniform Principal and Income Act provides that a trustee may not make an adjustment that reduces the actuarial value of the income interest in a trust intended to qualify a transfer for a gift tax exclusion.¹¹⁹ A trustee may also release the power to adjust, permanently or for a limited period of time, if the trustee is concerned that holding the power may impose unwanted tax burdens or cause problems along the lines of the list above.¹²⁰

The drafters of the Uniform Principal and Income Act intended the application of the power to adjust to be broad.¹²¹ Although language in a trust document may “opt out” of the power to adjust, most language will be construed to allow application of the Act unless it is clear that the terms intend to deny the power of adjustment.¹²² The comment to the Act suggests that instruments containing such provisions that are executed after the adoption of this Act should specifically refer to the power to adjust if the settlor intends to forbid its use.¹²³

It is important to note that although the Principal and Income Act is “uniform,” states have altered it in a myriad of ways. New Jersey has an interesting variation on the Principal and Income Act power to adjust. This state allows its trustees a 4% to 6% safe harbor amount—much like a

trustee did not have the power to make the adjustment; (2) that reduces the actuarial value of the income interest in a trust to which a person transfers property with the intent to qualify for a gift tax exclusion; (3) that changes the amount payable to a beneficiary as a fixed annuity or a fixed fraction of the value of the trust assets; (4) from any amount that is permanently set aside for charitable purposes under a will or the terms of a trust unless both income and principal are so set aside; (5) if possessing or exercising the power to make an adjustment causes an individual to be treated as the owner of all or part of the trust for income tax purposes, and the individual would not be treated as the owner if the trustee did not possess the power to make an adjustment; (6) if possessing or exercising the power to make an adjustment causes all or part of the trust assets to be included for estate tax purposes in the estate of an individual who has the power to remove a trustee or appoint a trustee, or both, and the assets would not be included in the estate of the individual if the trustee did not possess the power to make an adjustment; (7) if the trustee is a beneficiary of the trust; or (8) if the trustee is not a beneficiary, but the adjustment would benefit the trustee directly or indirectly.

Id.

If any of the last four factors applies to a trustee and there is more than one trustee, a co-trustee to whom the provision does not apply may make the adjustment unless the exercise of the power by the remaining trustee or trustees is not permitted by the terms of the trust. UNIF. PRINCIPAL & INCOME ACT § 104(d) (1997), 7B U.L.A. 141, 143 (2000).

119. *See id.* § 104(c)(2), at 142.

120. *See id.* § 104(e), at 143.

121. *See id.* § 104 cmt., at 143.

122. *See id.* § 104(f), at 143.

123. *See id.* § 104 cmt., at 143.

unitrust—that will be considered to be prudent.¹²⁴ Ohio provides a 4% safe harbor,¹²⁵ and Maryland includes a power to adjust, but only up to or down to 4%.¹²⁶ Colorado¹²⁷ and Tennessee¹²⁸ both added a section providing that a trustee has no duty to consider an adjustment.¹²⁹

Because the power to adjust is new and relatively untested, many trustees are not comfortable using it and are unsure of the margins of this

124. N.J. STAT. ANN. § 3B:19B-4 (West 2004) provides:

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

125. OHIO REV. CODE ANN. § 1340.42(G)(3) (Anderson 2003) provides:

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

126. MD. CODE ANN., EST. & TRUSTS § 15-502.2(c) (2003) provides:

Unless authorized by a court order in accordance with a petition filed under § 15-502.3 of this subtitle, a trustee may not make an adjustment under subsection (a) of this section in any accounting period if the adjustment results in a distribution of net income to the income beneficiary: (1) That is greater than 4% of the net fair market value of the trust assets on the first business day of that accounting period, if the net income for that accounting period is less than 4% as determined under this subtitle before application of the provisions of subsection (a) of this section; or (2) That is less than 4% of the net fair market value of the trust assets on the first business day of that accounting period, if the net income for that accounting period is greater than 4% as determined under this subtitle before application of the provisions of subsection (a) of this section.

127. COLO. REV. STAT. § 15-1-404(7) (2001) provides:

Nothing in this section or in this part 4 is intended to create or imply a duty to make an adjustment, and a trustee is not liable for not considering whether to make an adjustment or for choosing not to make an adjustment. In a proceeding with respect to a trustee's exercise or nonexercise of the power to make an adjustment under this section, the sole remedy is to direct, deny, or revise an adjustment between principal and income.

128. TENN. CODE ANN. § 35-6-104(g) (2002) provides that “[n]othing in this section [g] or in this chapter is intended to create or imply a duty to make an adjustment, and a trustee is not liable for not considering whether to make an adjustment or for choosing not to make an adjustment.”

129. It is also important to note that the power to adjust is but one small section of the Uniform Principal and Income Act. The Act also covers a variety of other situations relevant to trust allocations that are not central to this discussion of the ability of trustees to alter amounts paid to trust beneficiaries and are therefore not discussed in detail in this Article. *See* UNIF. PRINCIPAL & INCOME ACT, arts. 3-4, 7B U.L.A. 141 (1997). The Act includes rules for apportionment at the beginning and end of an income interest, special rules for types of receipts like timber and natural resources, and more. *See id.*

new approach. As one commentator puts it, “The boundaries [under the power to adjust], which will be different for each trust, are still not clear. Until case law begins to define those boundaries, some trustees may shy away from exercising this powerful discretionary tool for fear of lawsuits by the remaindermen.”¹³⁰ Even the titles of articles on the power to adjust, including *The New Uniform and Principal and Income Act: Friend or Foe?*¹³¹ and *The Trustee’s Power to Invest and to Adjust—Attended by No Small Degree of Anxiety and Trouble*,¹³² reflect a certain degree of discomfort with the new regime.

Despite the apprehension that naturally accompanies change, the power to adjust holds great promise. It allows trustees a wide range of flexibility and discretion, enabling payment of not just a fixed dollar amount but the most appropriate dollar amount given the trust’s circumstances.¹³³ The amounts distributed to the beneficiaries can vary each year, with attention given to their needs at the time, unlike the stagnant requirements of a unitrust election.¹³⁴ The discretionary nature of the power to adjust is also useful when the assets of the trust do not lend themselves to a distribution of principal in a certain year, for example, when the assets are illiquid.¹³⁵

Importantly, the power to adjust applies to a substantial base of trusts: those that define payments to beneficiaries based on income. Many other tools for balancing the interests of trust beneficiaries are far more limited in scope, applying only to charitable trusts or those in a small number of states. The widespread enactment of the power to adjust and the relative commonality of its application across different states will allow the development of case law and fiduciary practices to fine tune the boundaries of this rule.

130. See Turnipseed, *supra* note 10, at 247.

131. Avishai Glikman, *The New Uniform and Principal and Income Act: Friend or Foe?*, 31 MCGEORGE L. REV. 463, 473 (2000) (concluding that although the Uniform Principal and Income Act “raises the standard of care because it requires trustees to incorporate modern portfolio theory in their investment strategies,” it “is an important step toward bringing estate planning into the twenty-first century . . . [and] should modernize the administration of trusts for years to come”).

132. Suzanne W. Doggett, *The Trustee’s Power to Invest and to Adjust—“Attended by No Small Degree of Anxiety and Trouble,”* 27 TAX MGMT. EST., GIFTS & TR. J. 200 (July 11, 2002).

133. See UNIF. PRINCIPAL & INCOME ACT § 104 cmt., 7B U.L.A. 141 (1997).

134. Compare ME. REV. STAT. ANN. tit. 18-A, § 7-705 (West 2003), with UNIF. PRINCIPAL & INCOME ACT § 104(b).

135. See Robert B. Wolf, *Estate Planning with Total Return Trusts: Meeting Human Needs and Investment Goals Through Modern Trust Design*, 36 REAL PROP., PROB. & TR. J. 169 (2001) [hereinafter Wolf, *Estate Planning*].

B. Unitrusts

Another approach that softens the conflict between income and remainder beneficiaries is the use of a unitrust. In a unitrust, the income beneficiary receives a payment based on a percentage of the fair market value of the trust's assets, rather than a state law definition of trust accounting income.¹³⁶ This approach allows the trustee to invest for total return without regard to producing a certain level of income as it is traditionally defined by state law. Trustees in many states have the option of converting traditional "income" trusts to unitrusts under enabling legislation, either the state's Principal and Income Act or separate legislation. Trustees in states that are slower to adopt this approach may still attain unitrust treatment through court intervention or drafting.

Several states include a section in their state Principal and Income Act that allows trustees to determine the amount payable to current income beneficiaries based upon a percentage of fair market value: a unitrust election.¹³⁷ Statutory unitrusts are growing in popularity, and as of 2004, seventeen states have enacted unitrust legislation.¹³⁸ There is no uniform unitrust act, but there is a fair degree of conformity across the states on the critical provisions of the legislation. Maine's statute is fairly representative and is discussed as an example below.¹³⁹

Under Maine law, a trustee may elect to convert a trust to a unitrust without court intervention, provided that the beneficiaries are given notice and an opportunity to object.¹⁴⁰ The trustee may make the conversion only if it determines that the conversion will improve the ability of the trustee to carry out the intent of the settlor and the purposes of the trust.¹⁴¹ The unitrust election is an alternative to the power to adjust under the Principal and Income Act; the options are mutually exclusive.¹⁴²

After a trust is converted to a unitrust, the term "income" in the terms of the trust means an annual distribution equal to four percent of the net fair market value of the trust's assets, whether such assets would be considered income or principal, averaged over the lesser of the three preceding years or the period during which the trust has been in existence. Thus, if over the past three years the net fair market value of a trust

136. See Horn, *supra* note 35, at 30.

137. See *infra* app. B, which lists the states that have enacted unitrust legislation and the statutory reference for each state.

138. See *id.*

139. See ME. REV. STAT. ANN. tit. 18-A, § 7-705 (West 2003).

140. *Id.* § 7-705(a)(2).

141. *Id.* § 7-705(a)(1).

142. *Id.* § 7-705(a).

account is \$1,000,000, and the trust is converted into a unitrust, the trustee would distribute \$40,000 (4%) to the income beneficiaries.¹⁴³ A trustee who has converted a trust to a unitrust must follow an investment policy seeking a total return for the investments held by the trust, whether the return is to be derived from appreciation of capital, from earnings and distributions from capital, or from both.¹⁴⁴

The statute sets forth several factors that the trustee should consider when deciding whether to convert to a unitrust.¹⁴⁵ As in the Uniform Principal and Income Act, the list of factors is not exclusive, and a trustee is expected to consider all relevant facts and circumstances of the trust and its beneficiaries.¹⁴⁶

Certain trusts are not eligible for conversion to a unitrust under Maine's Act. A trust may not be converted if the terms of the document expressly prohibit the conversion.¹⁴⁷ Several other circumstances render a trust ineligible for unitrust conversion under Maine's Act, generally because the Legislature wanted to guard against unfavorable tax consequences.¹⁴⁸

143. *Id.* § 7-705(d)(3).

144. *Id.* § 7-705(d)(1).

145. *Id.* § 7-705(c). The factors are listed as follows:

- (1) The nature, purpose, and expected duration of the trust;
- (2) The identity and circumstances of the beneficiaries and, to the extent reasonably known to the trustee, the needs of the beneficiaries for present and future distributions authorized or required by the terms of the trust;
- (3) The needs for liquidity, regularity of income, and preservation and appreciation of capital;
- (4) 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;
- (5) Whether and to what extent the terms of the trust give the trustee the power to invade principal or accumulate income or prohibit the trustee from invading principal or accumulating income, and the extent to which the trustee has exercised a power from time to time to invade principal or accumulate income;
- (6) The actual and anticipated effect of economic conditions on principal and income and effects of inflation and deflation; and
- (7) The anticipated tax consequences of the conversion.

Id.

146. *Id.*

147. *Id.* § 7-705(a).

148. *Id.* § 7-705(i). Maine's Act provides:

A trustee may not convert a trust into a unitrust if any of the following applies:

- (1) 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) The unitrust distribution would be made from any amount that is permanently set aside for charitable purposes under a will or the terms of the trust unless both income and principal are so set aside;
- (3) The trustee's possession or exercise of the power to convert would cause an

As further protection against unwanted tax consequences, the Act allows a trustee the ability to release its power to convert a trust to a unitrust, either permanently or for a limited time.¹⁴⁹

Court intervention is available to (1) select a payout percentage other than 4%; (2) provide for a distribution of net income, as would be determined if the trust were not a unitrust, in excess of the unitrust distribution if such distribution is necessary to preserve a tax benefit; (3) average the valuation of the trust's net assets over a period other than three years; or (4) reconvert from a unitrust.¹⁵⁰ The court may also intervene if the beneficiaries disagree as to whether the trustee should make the unitrust election.¹⁵¹

The Act clarifies that a conversion to a unitrust does not affect a provision in the terms of the trust directing or authorizing the trustee to distribute principal or authorizing a beneficiary to withdraw a portion or all of the principal.¹⁵² It also provides guidance on the proper participation of co-trustees,¹⁵³ the administrative details that may be determined within the trustee's discretion,¹⁵⁴ and appropriate principal and income allocations under the unitrust model.¹⁵⁵

Some states have an approach to the unitrust alternative that is more flexible than the Maine Act, allowing a range of unitrust percentages rather than a set number. For example, Florida offers its trustees a range of reasonable choices: a trustee may select a percentage between 3% and 5%.¹⁵⁶ Trustees who are not "disinterested"—who may be biased to select a higher or lower number within that range based upon their own stake in

individual to be treated as the owner of all or part of the trust for income tax purposes, and the individual would not be treated as the owner if the trustee did not possess the power to convert;

(4) The trustee's possession or exercise of the power to convert would cause all or part of the trust assets to be included for estate tax purposes in the estate of an individual who has the power to remove a trustee or appoint a trustee, or both, and the assets would not be included in the estate of the individual if the trustee did not possess the power to convert;

(5) The conversion would result in the disallowance of an estate tax or gift tax marital deduction that would be allowed if the trustee did not have the power to convert; or (6) the trustee is a beneficiary of the trust.

Id.

149. *Id.* § 7-705(k).

150. *Id.* § 7-705(g).

151. *Id.* § 7-705(b).

152. *Id.* § 7-705(h).

153. *Id.* § 7-705(j).

154. *Id.* § 7-705(c).

155. *Id.* § 7-705(f).

156. FLA. STAT. ANN. § 738.1041 (West Supp. 2004).

the matter—are guided to an objective number within that range by referring to the Applicable Federal Rate for that month, as defined in section 7520 of the Internal Revenue Code.¹⁵⁷ Delaware, likewise, allows trustees to select a percentage within a 3% to 5% range.¹⁵⁸

Unitrust statutes need not be part of a state's Uniform Principal and Income Act. New York includes its unitrust provision as part of its Prudent Investor Act, rather than its Principal and Income Act.¹⁵⁹ New Hampshire enacted a separate unitrust statute, the Uniform Trustee's Power Act,¹⁶⁰ and has not enacted the 1997 Uniform Principal and Income Act. Unitrust statutes that are not part of a state's Principal and Income Act retain the basic elements of a unitrust approach. For example, New Hampshire's unitrust statute incorporates no provisions of the Uniform Principal and Income Act, but allows trustees to define income as an annual distribution equal to 5% of the net fair market value of the trust's assets as determined at the end of the calendar year.¹⁶¹ This applies regardless of whether such assets otherwise would be considered income or principal averaged over the lesser of the three preceding years or the period during which the trust has been in existence.¹⁶²

In states that have not yet adopted unitrust legislation, trustees may petition the court to alter the definition of income for a particular trust. The right of the judiciary to reform a trust in this manner often rests on an argument of changed circumstances or other equitable concerns. A petition to reform an income trust to a unitrust often uses similar language as the unitrust statutes—explaining that income is to be defined as a set percentage of fair market value and including administrative provisions. When a petition to reform an income trust to a unitrust involves unborn or unascertained beneficiaries, a guardian ad litem must be involved, and persuading the guardian of the advantages to remaindermen as well as income beneficiaries will be key to the success of the conversion.¹⁶³

157. Section § 738.1041(2)(b)(2)(a) provides:

The percentage used to calculate the unitrust amount is 50 percent of the applicable federal rate as defined in the Internal Revenue Code, 26 U.S.C. § 7520, in effect for the month the conversion under this section becomes effective and for each January thereafter; however, if the percentage calculated exceeds 5 percent, the unitrust percentage shall be 5 percent and if the percentage calculated is less than 3 percent, the unitrust percentage shall be 3 percent

158. See DEL. CODE ANN. tit. 12, § 3527 (2003).

159. See N.Y. EST. POWERS & TRUSTS LAW § 11-2.1 (McKinney 2004).

160. N.H. REV. STAT. ANN. § 564-A:3-c (2003).

161. *Id.*

162. See *id.* § 564-A:3-c(IV)(c).

163. See ERIC P. HAYES ET AL., ADVANCED ISSUES ON TRUST ADMINISTRATION, TOTAL RETURN UNITRUSTS, § 4, at 213–33 (MCLE Inc. 2003) (providing an excellent example of a

Trustees should be aware that converting an income trust to a unitrust through judicial intervention may cause tax problems. In *Cottage Savings Association v. Commissioner*,¹⁶⁴ the Supreme Court held that a loss or gain can be recognized when parties exchange similar property.¹⁶⁵ In this case, banks swapped mortgages that were very similar in substance and economic value, and the court found that the banks recognized capital gain on the swap.¹⁶⁶ Similarly, in *Evans v. Commissioner*,¹⁶⁷ the Tax Court found a taxable exchange when a beneficiary received a fixed annuity in a trust in return for her income interest.¹⁶⁸ The recent regulations to section 643 of the Internal Revenue Code have alleviated the concern that statutory unitrust conversions will trigger capital gains tax, but the regulations are not clear that the same protection is afforded to judicial reformations.¹⁶⁹ Massachusetts practitioners have noted anecdotally that the *Cottage Savings* issue has been a point of contention for the IRS when it has been asked to grant favorable rulings on judicial conversions to unitrusts.¹⁷⁰

For practitioners who are fortunate enough to be in the planning stages rather than being faced with an irrevocable document, drafting a trust to pay the lead beneficiary a unitrust interest rather than trust accounting income may be an excellent option to consider.¹⁷¹

guardian ad litem's report agreeing to convert to a 4.5% unitrust, the reports of Thomas P. Jalkut of Nutter, McClellan & Fish, included with his permission in this volume).

164. *Cottage Sav. Ass'n v. Comm'r*, 499 U.S. 554 (1991).

165. *See id.* at 567–68.

166. *Id.* at 568.

167. 30 T.C. 798 (1958).

168. *See id.* at 807.

169. *See* Treas. Reg. § 1.643(b)-1 (2004). With respect to non-statutory unitrust conversions, the regulation provides in relevant part:

A switch to a method not specifically authorized by state statute, but valid under state law (including a switch via judicial decision or a binding non-judicial settlement) may constitute a recognition event to the trust or its beneficiaries for purposes of section 1001 and may result in taxable gifts from the trust's grantor and beneficiaries, based on the relevant facts and circumstances.

Id.

170. ERIC P. HAYES ET AL., *ADVANCED ISSUES ON TRUST ADMINISTRATION, MODIFYING TRUSTS* § 2, at 70 (MCLE Inc. 2003). The *Cottage Savings* issue is not a threat for tax-exempt trusts, making judicial intervention a more appealing approach for trustees of charitable trusts seeking to reform to a unitrust absent an enabling statute. In Massachusetts, where there is no Principal and Income Act and no unitrust statute (although both have been proposed), judicial reformation has been a fairly common and successful approach for charitable trusts. *See* HAYES ET AL., *supra* note 163, at 213–33.

171. *See* Collins & Stampfli, *supra* note 11, at 205; Patrick J. Collins et al., *Financial Consequences of Distribution Elections from Total Return Trusts*, 35 REAL PROP., PROB. & TR. J. 243, 246–66 (2000); James P. Garland, *The Problems with Unitrusts*, J. PRIVATE PORTFOLIO MGMT. (Spring 1999). Commentators, such as Robert Wolf and his associates, have written eloquently

The primary benefit of converting an income trust to a unitrust is that it consolidates the investment objectives of the current and future beneficiaries and enables the trustee to invest for total return. The amount to be distributed is objective and, presumably, fair. This may appeal to beneficiaries, particularly those who tend toward less cooperative relationships with each other. The unitrust, as opposed to the power to adjust or other more variable balancing techniques, provides a reasonable amount of predictability to current beneficiaries, although, of course, there may be variations in the market value from year to year.¹⁷² The unitrust is also simpler and more straightforward to administer for a trustee—and arguably requires less judgment and expertise—than techniques that require the repeated exercise of a discretionary power.

The unitrust approach, however, does have several drawbacks. Many trustees believe the percentages expressed in the statutes are too high to be sustainable over the long term,¹⁷³ and some mourn their loss of discretionary control.¹⁷⁴ Judicial intervention is generally needed to opt out of a unitrust once the trustee has opted in,¹⁷⁵ and this procedure may be time-consuming and expensive. The unitrust model may also be inappropriate for certain types of trusts, including those listed in the statutes,¹⁷⁶ trusts with illiquid assets, spendthrift trusts, and trusts subject to generation-skipping transfer tax.¹⁷⁷ The unitrust is also inappropriate for private foundation trusts or other trusts subject to section 4942 of the Internal Revenue Code, unless the unitrust percentage is high enough to allow the trustees to meet the minimum distribution of approximately 5%.¹⁷⁸

about the role of unitrusts. Mr. Wolf's series of articles, often discussed at the Annual University of Miami Philip E. Heckerling Institute on Estate Planning, provide valuable detail and quantitative analyses supporting the total return unitrust approach. See Wolf, *Estate Planning*, *supra* note 135; Wolf, *Defeating the Duty*, *supra* note 36; Robert B. Wolf, *Total Return Trusts—Can Your Clients Afford Anything Less?*, 33 REAL. PROP., PROB. & TR. J. 131, 134–35 (1998).

172. Smoothing rules, which average the fair market value over several years, can help minimize this volatility. For an example of a unitrust smoothing rule, see N.H. REV. STAT. ANN. § 564-A:3-c(IV)(c) (2003).

173. Some commentators have suggested that the consensus of the estate planning community is that a payout range between 3% and 5% should, over time, be sustainable. See Zaluda, *supra* note 6 at 155; Turnipseed, *supra* note 10, at 244 (suggesting that most trustees believe the common 4% statutory unitrust amount is too high in this investment return environment, and that in 2003, many were using the power to adjust to pay out between 3.25% and 3.5%).

174. See Turnipseed, *supra* note 10, at 244.

175. See, e.g., ME. REV. STAT. ANN. tit. 18-A, § 7-705(g) (West 2003).

176. See, e.g., *id.* § 7-705(i).

177. See Turnipseed, *supra* note 10, at 244.

178. See I.R.C. § 4942 (2002).

Judicial unitrusts have even more drawbacks than statutory unitrust elections. In addition to the legal fees for drafting the petition, the involvement of guardians ad litem or representatives of charities, including the state attorney general or other charitable officials, may add further expense. Furthermore, the judicial process is not quick, and a petition may take months or years to make it through the docket. Tax concerns, most notably fear of triggering capital gain tax under *Cottage Savings*, also dampen enthusiasm for judicial unitrusts, except for where charitable trusts that are protected from such taxes are at issue.

C. The Uniform Management of Institutional Funds Act

Charitable trusts have an additional tool that is not available to private trusts. The Uniform Management of Institutional Funds Act (“UMIFA”) represents an attempt to provide a balance between income needs and preservation of capital for trustees of charitable trusts.¹⁷⁹ When the statute was drafted, there was a concern that charitable organizations were investing their endowments too conservatively.¹⁸⁰ “The UMIFA solution was to give universities the power to invest under a more liberal prudent person rule and to allow colleges to use either the traditional principal and income rule or a total return standard when making annual spending decisions.”¹⁸¹ Since being introduced in 1972, UMIFA has been adopted by forty-six states.¹⁸²

UMIFA was promulgated in 1972 by the National Conference of Commissioners on Uniform State Laws.¹⁸³ It was intended to provide guidance to the governing boards of charitable institutions with respect to investing their endowments and other funds.¹⁸⁴ Before UMIFA was drafted, the law was uncertain and many governing boards erred on the side of conservatism for fear of liability.¹⁸⁵ UMIFA was designed as a “rational solution to these problems.”¹⁸⁶

UMIFA applies to charitable organizations and to trusts held for

179. See Halbach, *supra* note 5, at 1912.

180. See Dobris, *supra* note 103, at 52.

181. *Id.*

182. See UNIF. MGMT. OF INSTITUTIONAL FUNDS ACT § 1, 7A U.L.A. 475 (West Supp. 2004) (table of jurisdictions).

183. See Carol G. Kroch, *UMIFA*, SJ039 ALI-ABA 27, 29 (Dec. 2003). This action by the NCCUSL is merely a recommendation. The uniform act must then be adopted by individual states before it has any binding authority. See Halbach, *supra* note 5, at 1881.

184. See UNIF. MGMT. OF INSTITUTIONAL FUNDS ACT prefatory note, 7A U.L.A. 476 (1972).

185. See *id.*

186. *Id.*

charitable institutions as long as the trustee is also a charitable institution.¹⁸⁷ Section 2 establishes the following spending rule for institutions covered by UMIFA:

The governing board may appropriate for expenditure for the uses and purposes for which an endowment fund is established so much of the net appreciation, realized and unrealized, in the fair value of the assets of an endowment fund over the historic dollar value of the fund as is prudent under the standard established by Section 6. This Section does not limit the authority of the governing board to expend funds as permitted under other law, the terms of the applicable gift instrument, or the charter of the institution.¹⁸⁸

This section allows the governing board to spend capital appreciation and does not limit them to spending income.¹⁸⁹ As a result, they can invest for overall return, consistent with the total return theory discussed in Part II.B above.¹⁹⁰

For example, a trustee of a \$1,000,000 charitable trust with an original funding amount of \$600,000 and a 2% (\$20,000) return on income-producing investments may rely on UMIFA to make distributions in excess of trust accounting income by appropriating a reasonable amount (say \$25,000) from the appreciation of the corpus for current distribution. The trustee could then distribute to the income beneficiary the trust accounting income (\$20,000) plus the amount appropriated from the appreciation of the corpus (\$25,000), for a greater total distribution (\$45,000). When exercising discretion, the trustee will be guided by limits in applicable state statutes.

UMIFA emphasizes that section 2 does not apply if it contravenes a donor's intention.¹⁹¹ This section is interpreted strictly so that a governing board can employ UMIFA unless the instrument expressly prohibits the spending of appreciation. A restriction is not implied merely where an instrument limits spending to income or interest or requires preservation of principal.¹⁹²

UMIFA also provides the governing board with guidance with respect to investment policies.¹⁹³ Section 4 makes it clear that the governing board of a charitable institution is not subject to the same limitations imposed on

187. *See id.* § 1, at 484.

188. *Id.* § 2, at 491.

189. *See id.* § 2 cmt., at 491.

190. *See id.* at prefatory note, at 476.

191. *Id.* § 3, at 491.

192. *Id.*

193. *See id.* § 4, at 495.

private trustees.¹⁹⁴ This broad power provides that they may

invest and reinvest an institutional fund in any real or personal property deemed advisable by the governing board, whether or not it produces a current return, including mortgages, stocks, bonds, debentures, and other securities of profit or nonprofit corporations, shares in or obligations of associations, partnerships, or individuals, and obligations of any government or subdivision or instrumentality thereof.¹⁹⁵

This section also gives the governing board the authority to retain any investments contributed by a donor, and invest in a pooled or common fund maintained by the institution or any other pooled or common fund, such as "regulated investment companies, mutual funds, common trust funds, investment partnerships, real estate investment trusts, or similar organizations."¹⁹⁶ UMIFA also provides that the governing board may delegate investment decisions to other members of the institution and hire outside professional advisors to make decisions.¹⁹⁷

The entirety of UMIFA, and in particular the spending rule of section 2, must be read in conjunction with section 6, which imposes a standard of prudence for all of the governing board's actions.¹⁹⁸ Thus, the governing board is required to

exercise ordinary business care and prudence under the facts and circumstances prevailing at the time of the action or decision. In so doing they shall consider the long and short term needs of the institution in carrying out its educational, religious, charitable or other eleemosynary purposes, its present and anticipated financial requirements, expected total return on its investments, price level trends, and general economic conditions.¹⁹⁹

This standard of care is based on the rules applicable to managers of private foundations and is more similar to the conduct required of corporate officers as opposed to trustees.²⁰⁰ It "requires a member of a governing board to weigh the needs of today against those of the future."²⁰¹

The comments to UMIFA note that restricted gifts may pose a problem if they become impractical to administer.²⁰² Section 7 permits a

194. *See id.* § 4 cmt., at 495.

195. *Id.* § 4(1), at 495.

196. *Id.* § 4(4), at 495.

197. *See id.* § 5, at 498. This was a significant departure from the law of private trusts in 1972. *Compare* UNIF. MGMT. OF INSTITUTIONAL FUNDS ACT § 5, 7A U.L.A. 498 (1972), *with* RESTATEMENT (SECOND) OF TRUSTS § 171 (1959).

198. UNIF. MGMT. OF INSTITUTIONAL FUNDS ACT § 6, 7A U.L.A. 500 (1972).

199. *Id.*

200. *See id.* § 6 cmt., at 500.

201. *Id.*

202. *See id.* § 7 cmt., at 503.

governing board to release a restriction with the written consent of the donor.²⁰³ If the donor is unavailable, the governing board may apply in court for a release.²⁰⁴

In 2002, the National Conference of Commissioners on Uniform State Laws formed a committee to revise UMIFA in light of the UPIA and the Uniform Trust Code.²⁰⁵ The most recent draft issued by the committee is dated August 25, 2004 (referred to hereinafter as the “2004 Draft UMIFA”).²⁰⁶ The committee continues to meet, and it is expected that the revision will not be finished before the end of 2005.²⁰⁷ The most recent draft makes several major changes to UMIFA.²⁰⁸

A critical change made by the 2004 Draft UMIFA is the broadening of the definition of institutions covered by the Act to encompass all charitable trusts, regardless of the identity of the trustee.²⁰⁹ It would apply to split interest trusts, such as charitable remainder trusts, only if the noncharitable interests have terminated.²¹⁰ This new provision has already been enacted by several state legislatures—even before the next version of UMIFA becomes final.²¹¹ Thus, third party trustees (including banks and professional fiduciaries) are now operating under UMIFA in several states.

Perhaps the most controversial proposal introduced by the 2004 Draft UMIFA is a new spending rule to replace former section 2 of UMIFA.²¹² Instead of historic dollar value, the 2004 Draft UMIFA gives the institution the discretion “to expend or accumulate so much of an endowment fund as the institution determines to be prudent for the uses, benefits, purposes, and

203. See *id.* § 7(a), at 503.

204. See *id.* § 7(b), at 503.

205. See Kroch, *supra* note 183, at 29.

206. A copy of the draft can be found at the website of the NCCUSL. See NCCUSL, 2004 ANNUAL MEETING APPROVED TEXT OF THE FINAL ACTS NOW AVAILABLE LINK, at <http://www.nccusl.org> (last accessed Sept. 22, 2004) [hereinafter DRAFT UMIFA].

207. See Memorandum from Susan Gary, to Members of the Drafting Committee and Observers (Aug. 25, 2004), available at <http://www.law.upenn.edu/bll/ulc/umoifa/Aug2004memo.htm> (last accessed Jan. 9, 2005).

208. Compare UNIF. MGMT. OF INSTITUTIONAL FUNDS ACT, 7A U.L.A. 484 (1972), with DRAFT UMIFA, *supra* note 206.

209. See DRAFT UMIFA, *supra* note 206, § 2(4). The American Bankers Association has recommended that the drafting committee should not include the provision extending UMIFA to all charitable trusts. See Letter from Lisa J. Bleier, Senior Trust Counsel, American Bankers Association Trust Counsel Committee, to Susan Gary and Carol Kroch (December 3, 2004) (on file with U.S.F. Law Review).

210. See *id.*

211. See 13 ME. REV. STAT. ANN. tit. 18-A, § 4100 (West 2003); N.H. REV. STAT. ANN. § 292-B (2004).

212. DRAFT UMIFA, *supra* note 206, § 4 cmt.

duration for which the endowment fund is established.”²¹³ In exercising this discretion, the institution is subject to a standard of prudence.²¹⁴ The institution is instructed to consider certain factors, which are similar to the factors set out in the prudence standard of the UPIA.²¹⁵ As in the current UMIFA statute, donor intent takes precedence over this spending rule.²¹⁶ The draft rule grants institutions more flexibility in making expenditures because the drafting committee believed that institutions were still spending too conservatively under the current standard.²¹⁷ It is notable that some states that have already adopted the 2004 Draft UMIFA provision extending the reach of the Act to third party trustees have declined to include the provision removing the reference to historic dollar value.²¹⁸ A recent memo from the Reporter of the Drafting Committee acknowledges that some commentators are concerned about the potential adverse effects of eliminating the historic dollar value rule and notes that the revision of the spending rule is still an open issue.²¹⁹

The standard of conduct found in UMIFA section 6 has also been revised to be consistent with the Uniform Prudent Investor Act.²²⁰ This section provides that those responsible for investing and managing an institutional fund shall act “with the care an ordinarily prudent person in a like position would exercise under similar circumstances.”²²¹ Like the new spending rule, this section also provides a long list of factors that should be considered.²²² The 2004 Draft UMIFA continues to permit delegation of management and investment functions, but has been reworded so that it is

213. *Id.* § 4(a).

214. *See id.*

215. *See id.* The factors are listed as follows: the duration and preservation of the endowment fund; the purposes of the institution and the endowment fund; general economic conditions; the possible effect of inflation or deflation; the expected total return from income and the appreciation of investments; other resources of the institution; and the investment policy of the institution. *Id.*

216. *See* DRAFT UMIFA, *supra* note 206, § 4(b).

217. *See id.* § 3 cmt.

218. *See* ME. REV. STAT. ANN. tit. 18-A § 4100 (West 2003); N.H. REV. STAT. ANN. § 292-B (2004).

219. *See* Memorandum from Susan Gary, *supra* note 207. The memorandum states:

A number of those commenting on the Act continue to be concerned that without greater guidance in the Act, charities will be tempted to spend more than is prudent. The Drafting Committee has also heard the concern that attorneys general will have difficulty regulating imprudent spending without a bright-line rule.

Id.

220. *See* DRAFT UMIFA, *supra* note 206, § 3 cmt.

221. *Id.* § 3(a)(2).

222. *See id.* § 3(c).

almost identical to section 9 of the Uniform Prudent Investor Act.²²³ Finally, the 2004 Draft UMIFA also makes it easier for an institution to obtain a release of restrictions on a gift.²²⁴

UMIFA, in its current form and as it is poised for progress, provides important opportunities for trustees of charitable trusts when balancing current and future interests. The ability to appropriate appreciation or accumulate income enables a trustee to invest for total return while still meeting beneficiary needs. UMIFA is flexible enough that most large charities have developed their own spending policies, which are consistent with UMIFA and function within its framework.²²⁵ In the states that have extended its reach beyond institutions managing their own funds, third party trustees using UMIFA are likely to find that sophisticated charitable beneficiaries are familiar with UMIFA and comfortable operating under its terms.

Making distribution adjustments using UMIFA does have some drawbacks. The appropriation of appreciation is tied to historic dollar value—a piece of information that is simply not available for some trusts, particularly older ones. Some argue that the reliance on historic dollar value is antiquated and bears no reasonable relationship to the current value of the trust.²²⁶ Additionally, distributions under UMIFA may vary substantially from year to year; this allows adjustment based in part upon charitable needs, but provides less certainty for income beneficiaries than distributions based upon a set percentage amount.

D. Private Foundation Tax Compliance Statutes

Trustees of private foundation trusts have an additional method to transfer more than mere trust accounting income to the current beneficiary: state statutes enabling compliance with Federal Tax Code requirements imposed on private foundations. These statutes, while not allowing the flexibility of an adjustment power or UMIFA appropriation, do allow a trustee to invest for total return without completely sacrificing the beneficiary's need for current income because they permit the limited distribution of principal.

223. Compare UNIF. PRUDENT INVESTOR ACT § 9, with DRAFT UMIFA, *supra* note 206, § 5.

224. DRAFT UMIFA, *supra* note 206, § 6 and cmt. In addition to the rule that a restriction may be released with consent of a donor, the 2004 Draft UMIFA would also permit an institution to release restrictions on small gifts that have been in place for over twenty years without applying to a court. The draft suggests that this section should apply to funds of \$25,000 or less. For larger gifts, the institution may apply to a court for *cy pres*, but need not notify the donor. *Id.*

225. See Dobris, *supra* note 103, at 51–53.

226. See Memorandum from Susan Gary, *supra* note 207.

Since the Tax Reform Act of 1969,²²⁷ private foundations have been subject to a series of tax rules that govern their investment and distribution practices.²²⁸ One of these rules is section 4942 of the Internal Revenue Code, which requires that private foundations meet a minimum distribution requirement of roughly 5% of the foundation's net assets each year.²²⁹ Foundations that do not comply with this requirement risk loss of their tax-exempt status,²³⁰ or penalties and fees, or both.²³¹

Many charitable trusts that are classified as private foundations are drafted as income-only trusts, and strict compliance with the terms of the trust would trigger violations of section 4942 and the resultant penalties.²³² To protect private foundations—particularly those drafted before the 1969 Act—from the dire consequences of the private foundation tax rules, all fifty states and the District of Columbia enacted legislation authorizing trustees to comply with the private foundation Tax Code requirements.²³³ This legislation is acknowledged by the Internal Revenue Service and is

227. Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 (codified as amended in scattered sections of 26 U.S.C.).

228. "Private foundation" is defined in section 509(a) of the Internal Revenue Code. See I.R.C. § 509(a) (2004).

229. Technically, the amount a private foundation must distribute is not exactly 5% of its fair market value. The foundation must instead distribute an amount based on its "minimum investment return." See I.R.C. § 4942(d) (2004). I.R.C. § 4942(c) provides:

[T]he minimum investment return for any private foundation for any taxable year is 5 percent of the excess of—(A) the aggregate fair market value of all assets of the foundation other than those which are used (or held for use) directly in carrying out the foundation's exempt purpose, over (B) the acquisition indebtedness with respect to such assets.

Foundations may also carry forward or set aside amounts in calculating this distribution. See *id.* However, the distribution amount is roughly five percent of the foundation's fair market value, and that shorthand will be used for the purposes of this Article. For an excellent summary of the mandatory distribution rules of section 4942, see BRUCE R. HOPKINS, *THE LAW OF TAX-EXEMPT ORGANIZATIONS* § 11.4(b), at 266–67 (7th ed. 1998 & Supp. 2001).

230. I.R.C. § 508(c) allows an exemption from tax only for private foundations that distribute 5% or more of their assets each year. See I.R.C. § 508(c) (2004).

231. I.R.C. § 4942(a) imposes a penalty tax of fifteen percent on foundations that fail to meet their minimum distribution requirement. See I.R.C. § 4942(a) (2004).

232. See Thomas J. Brorby, *Using State Law to Amend Foundations' Governing Instruments Under 508(e)*, 34 J. TAX'N 170, 170 (1971).

233. Rev. Rul. 75-38, 1975-1 C.B. 161, provides a list of states that have enacted private foundation tax compliance statutes. This Revenue Ruling is attached *infra* as Appendix D. For more background on the enactment of state statutes authorizing private foundation trustees to comply with the requirements of the 1969 Tax Reform Act, see Brorby, *supra* note 232, at 170; Lauren W. Cesare, *Private Foundations and Public Charities—Termination (§507) and Special Rules (§508)*, 877 TAX MGMT. PORTFOLIOS A-27 (2d ed., BNA 2001); Marion Fremont-Smith, *Impact of the Tax Reform Act of 1969 on State Supervision of Charities*, 8 HARV. J. ON LEGIS. 537 (1971).

effective to allow trustees to comply with the Tax Code requirements.²³⁴ It applies to the vast majority of private foundation trusts, although those with clear grantor intent to the contrary may continue to operate under their income-only terms and accept the concomitant tax penalties.²³⁵

Most of these state statutes were enacted shortly after the 1969 Act (between 1969 and 1972) and were based on the model statutory language advanced by the American Bar Association.²³⁶ The language in the Connecticut statute, for example, is based on the American Bar Association model language,²³⁷ and states:

In the administration of any trust which is a private foundation or a charitable trust, as defined in subdivision (1), during the period while it is such a foundation or trust, amounts shall be distributed for the purposes specified in the trust instrument, in such manner and at such times as are at least sufficient to avoid liability for the tax imposed by Section 4942 of said code.²³⁸

The purpose of these statutes was to allow compliance with the Tax Reform Act of 1969—but an important side effect is that they allow distribution of principal from income-only trusts, thus mitigating the conflict between investing for trust accounting income and principal. The 5% minimum distribution requirement of section 4942 of the Internal Revenue Code essentially transforms these income-only trusts into quasi-unitrusts—requiring distribution of principal to the extent trust accounting income is insufficient to meet the financial target. This enables total return investing.

The private foundation tax compliance statutes allow countless foundations to avoid needless penalty taxes, but their scope is limited to trusts that are classified as private foundations. The statutes also contain no flexibility or discretion—additional distributions are permitted only to the extent needed to meet the distribution requirement of section 4942, down to the dollar.

Another weakness of private foundation tax compliance statutes is the uncertainty of the Tax Code section it supports: section 4942. As charitable organizations come under increased scrutiny, reform of the tax rules that apply to them seems likely. The 5% distribution requirement of section 4942 may be increased or redefined, and the rules applying to private

234. See Rev. Rul. 75-38; Treas. Reg. § 1.508-3(d).

235. See Cesare, *supra* note 233, at A-27.

236. See Fremont-Smith, *supra* note 233, at 547-48.

237. See J. Danford Anthony, *Private Foundation Governing Instrument Requirements: 1971 Connecticut Public Acts Nos. 219 and 220*, 46 CONN. B.J. 287, 299 (1972).

238. CONN. GEN. STAT. § 33-281c(a)(2) (2003).

foundations may be changed dramatically.²³⁹ State statutes may need to be amended to reflect changes in the federal tax laws.

E. A Unique State-Specific Approach—Section 8113 of the Pennsylvania Statutes

The four main statutory schemes discussed above are not the exclusive methods of allowing trustee distribution flexibility. States may also, of course, enact their own creative solutions. This Article reviews one unique approach in detail. Pennsylvania, as part of its Principal and Income Act, includes a provision specific to charitable trusts that allows “income” to be defined as an amount between 2% and 7% of the fair market value of the trust each year, with the percentage amount determined annually.²⁴⁰

239. See SENATE FINANCE COMM., DISCUSSION DRAFT: REFORMS AND BEST PRACTICES IN TAX-EXEMPT ORGANIZATIONS, available at <http://www.finance.senate.gov/hearings/testimony/2004test/062204stfdis.pdf> (last accessed Sept. 28, 2004) (discussing various reforms to tax-exempt organization rules).

240. See 20 PA. CONS. STAT. ANN. § 8113 (West 2004). This statute is part of Pennsylvania’s Principal and Income Act and provides as follows:

(a) **Election.**—Notwithstanding the foregoing provisions of this chapter, the trustee of a trust held exclusively for charitable purposes may elect to be governed by this section unless the governing instrument expressly provides that the election provided by this section shall not be available.

(b) **Eligibility for election.**—To make an election under this section, the trustee shall adopt and follow an investment policy seeking a total return for the investments held by the trust, whether the return is to be derived from appreciation of capital or earnings and distributions with respect to capital or both. The policy constituting the election shall be in writing, shall be maintained as part of the permanent records of the trust and shall recite that it constitutes an election to be governed by this section.

(c) **Effect of election.**—If an election is made to be governed by this section, the term “income” shall mean a percentage of the value of the trust. The trustee shall, in a writing maintained as part of the permanent records of the trust, annually select the percentage and determine that it is consistent with the long-term preservation of the real value of the principal of the trust, but in no event shall the percentage be less than 2% nor more than 7% per year. The term “principal” shall mean all other assets held by the trustee with respect to the trust.

(d) **Revocation of election.**—The trustee may revoke an election to be governed by this section if the revocation is made as part of an alternative investment policy seeking the long-term preservation of the real value of the principal of the trust. The revocation and alternative investment policy shall be in writing and maintained as part of the permanent records of the trust.

(e) **Value determination.**—For purposes of applying this section, the value of the trust shall be the fair market value of the cash and other assets held by the trustee with respect to the trust, whether such assets would be considered “income” or “principal” under the other provisions of this chapter, determined at least annually and averaged over a period of three or more preceding years. However, if the trust has been in existence less than three years, the average shall be determined over the period during which the trust has been in existence.

Id.

Rather than requiring a set unitrust percentage that endures for the life of the trust, this statute enables the trustee to adjust the amount based on prevailing circumstances at the time of the distribution.

This statute is an interesting hybrid of a unitrust statute and UMIFA. Since Pennsylvania has no UMIFA, section 8113 functions, in part, as a UMIFA substitute. It is notable that Pennsylvania does have both the power to adjust²⁴¹ and a straight 4% unitrust statute,²⁴² but apparently the legislature felt these two options were insufficient for charitable trusts. The comments to the statute by the Pennsylvania legislature are illuminative:

The law governing charitable trusts does not currently permit the trustees to adopt a “spending policy” in connection with the management of endowment or other trust funds on a “total return” basis. In any situation where the trust is required to spend “income”, all dividends and interest must be expended, none can be added to principal even in years in which the income is extraordinarily high. On the other hand, realized capital gains must all be allocated to principal, even in years in which the ordinary dividend and interest yield is low.

....

The percentages stated reflect a judgment as to the range of “yields” within which a spending policy may be appropriate. The upper limit is actually more than would be considered prudent in long-term management of a trust. Nevertheless, some flexibility should be allowed so the trustees can adjust to the specific needs of a charity from time to time. A limit at the low end is proposed to ensure that, in cases where the trust requires the current expenditure of income, the trustee cannot subvert this requirement by defining income to be zero.

The above rules are necessary only in connection with trusts which state that only the income can be expended currently. Trusts which allow the application of both principal and income can be managed on a total return basis in any event.²⁴³

Interestingly, the Pennsylvania Legislature believed that this special charitable quasi-unitrust option would be of no use to private foundations, which already had a private foundation tax compliance statute. Section 8113 states:

[C]haritable trusts that are private foundations for Federal income tax purposes already have the ability to expend ‘principal’ to the extent provided in section 1 of the act of June 17, 1971 (P.L. 181, No. 23). Accordingly, this provision will provide needed flexibility primarily to those charitable trusts that are not private foundations.²⁴⁴

Although the Pennsylvania statute is creative and flexible, its limited

241. 20 PA. CONS. STAT. ANN. § 8104 (West 2004).

242. *Id.* § 8105.

243. *Id.* § 8113 cmt.

244. *Id.*

scope—to Pennsylvania charitable trusts that are not private foundations—makes it an option that is generally unavailable to trustees. State-specific approaches also counter the goal of uniformity of law in different jurisdictions and run the risk of becoming obscure and underutilized. Approaches that are used by only one state also have less opportunity to be tested and to develop supporting case law to help trustees learn the boundaries of the statute.

III. A Comparison of the Alternatives and an Example of Their Application

Fortunate trustees may find themselves with several tools that they could choose to alter the amount paid to the current beneficiary. Which tool is best? The following hypothetical will examine the four options available in Maine to a private trust and to a charitable trust: the power to adjust, the unitrust, UMIFA, and the private foundation tax compliance statute. Each option will be examined independently with attention to the impact it will have on the trust distribution amount.

Assume that the same bank acts as the trustee for two trusts that were funded in 1975 with \$600,000 and are currently valued at \$1,000,000. The first trust is an irrevocable private trust that provides that all of the income is to be paid to the grantor's second wife for life with the remainder to the grantor's children from his first marriage. The second trust is a charitable trust that directs all of the income to be paid to a local charity in perpetuity.²⁴⁵ Both trusts are invested for total return, with 20% in bonds and 80% in equities. Last year, each trust produced a 2.0% return in income (\$20,000) and a 7.0% return (\$70,000) on its equity investments, and this is consistent with its performance over the past several years. The income beneficiaries have expressed a need for a greater payout this year. What options does the trustee have in determining the amount to pay, and what tools work best?

Table 1: Options Available to a Trustee in Maine

245. Depending upon the other terms of the trust, it might qualify as either a supporting organization under I.R.C. § 509(a)(3) or a private foundation under I.R.C. § 509(a)(4). Even though an income-only trust would not by its terms comply with the distribution requirements of a private foundation under federal tax law, the local private foundation tax compliance statute will enable the trustee to meet these requirements. *See* Treas. Reg. § 1.508-3(d) (2004) & Rev. Rul. 75-38, 1975-1 C.B. 161. Careful drafters of private foundation trusts, however, generally will comply with the tax requirements in the document itself rather than relying on corrective legislation.

Options Available to a Trustee in Maine			
Available for Charitable and Private Trusts		Available for Charitable Trusts Only	
Exercise the power to adjust.	Convert to a unitrust.	Appropriate appreciation under UMIFA.	Distribute principal under the private foundation tax compliance statute.
ME. REV. STAT. ANN. tit. 18-A § 7-704.	ME. REV. STAT. ANN. tit. 18-A § 7-705.	ME. REV. STAT. ANN. tit. 13 § 4102.	ME. REV. STAT. ANN. tit. 18-A § 7-407.
Allows trustee to allocate receipts or expenses allocated to income under trust accounting rules to principal, or vice versa.	Allows trustee to elect to convert to a 4% unitrust.	Allows trustee to appropriate appreciation in light of historic dollar value. ²⁴⁶	Allows trustee to distribute principal to meet the 5% distribution requirement of § 4942 of the U.S. Tax Code.

If the trustee chose to apply the power to adjust under the Principal and Income Act, it would apply the factors listed in the Maine statute and attempt to determine what additional distribution is needed to be “fair and reasonable” to the beneficiaries given the trust’s investment approach and all relevant circumstances. Arriving at a precise number would be no small feat. Should the trustee scrutinize particular items of income or expense and determine whether they should be reallocated? Should the trustee estimate what would be a reasonable return to which the income beneficiary is entitled? Should the trustee determine what a sustainable payout would be as a percentage of corpus, or a range of sustainable payouts and decide upon an amount to transfer based on that number? Would it be helpful to analogize to the New Jersey statute and presume that a distribution in the range of 4% to 6% of the trust’s fair market value is reasonable? There are no clear answers and no clear guidance—trustees operating under the power to adjust have broad discretion, with its accompanying freedom and risks.

Let us assume that the trustee decides, based on all of the relevant factors, that it is defensible under the Principal and Income Act to pay out an amount between 2% (\$20,000; making no adjustment) and 6% (\$60,000). After doing research, the trustee concludes that an annual distribution of between 3% and 4% would be consistent with the competing goals of providing for the current needs of the income beneficiary and

246. Note that Maine’s Uniform Management of Institutional Funds Act does not set a percentage limitation on the amount of appropriation that would be prudent. *See* 13 ME. REV. STAT. ANN. tit. 18-A, §§ 4100-1 (West 2003). *Compare* N.H. REV. STAT. ANN. § 292-B (2004) (suggesting that appropriating amounts above 7% are likely imprudent).

preserving principal for the remainder beneficiaries. Given the beneficiary's expressed needs for current income and the favorable investment performance of the trust in the past year, the trustee decides that a payout of \$35,000 is best. The trustee transfers \$15,000 from principal to income and distributes this amount to the income beneficiary in addition to the \$20,000 of trust accounting income.

As an alternative, the trustee may consider converting to a unitrust. Again, the trustee must apply the factors listed in the unitrust statute in light of the trust's circumstances. The statutory unitrust amount in Maine is 4%, which would entitle the income beneficiary to a distribution of \$40,000. Here, there is no controversy over the distribution amount (unless the parties wish to litigate it), since the amount is statutorily set. Unfortunately, in exchange for this certainty, the trustee loses any flexibility to meet the beneficiaries' potential future needs.

Both of the above options—the power to adjust and the unitrust election—are also available to the trustee for the charitable trust. For a charitable trust, however, the additional opportunities to appropriate appreciation under the Uniform Management of Institutional Funds Act and/or (if the trust is a private foundation) to utilize the private tax compliance statute come into play.

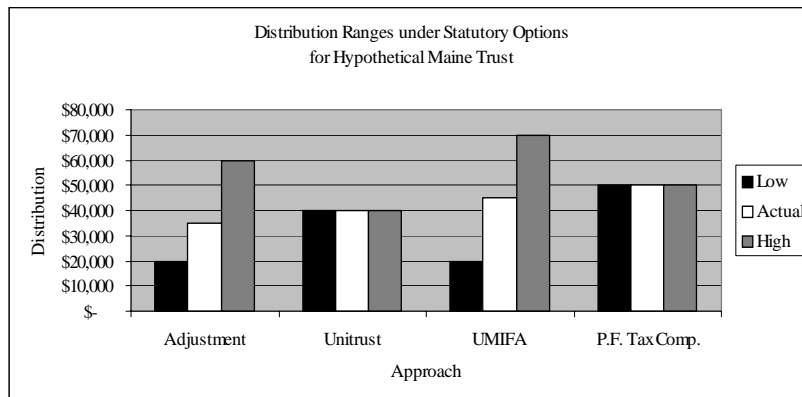
With respect to the charitable trust, the trustee may now analyze what distributions would be proper under the Uniform Management of Institutional Funds Act. As a bank, the trustee is new to applying the statute, but the charitable beneficiary has been using it to manage its own sizable endowment for years. Under UMIFA, the trustee must first compare the historic value of the trust to its current value, to determine how much appreciation there is. In our hypothetical, the trust has grown by \$400,000 since its inception. The trustee must then consider how much of this \$400,000 is prudent to appropriate and distribute, given the factors listed in the UMIFA statute and the circumstances of the trust. Although Maine's UMIFA statute does not set an upper percentage limit on what would be considered prudent, the trustee may take guidance from New Hampshire's act, which suggests that an amount beyond 7% (\$70,000) is probably not sustainable. The trustee refers to the research it examined during its contemplation of the power to adjust and concludes that an annual distribution of between 3% and 5% would be consistent with the goal of long-term preservation of principal, since the trust operates in a tax-free environment and is subject to very low fees.

Given the beneficiaries' expressed needs for current income, the tax-exempt status of the trust, and the favorable investment performance of the trust in the past year, the trustee decides that a payout of \$45,000 is best.

The trustee is comfortable distributing somewhat more under UMIFA than under the power to adjust because (1) the trustee is now taking into account the historic dollar value of the trust and its healthy growth over the past several decades, and (2) the trustee is comparing its percentage distribution to the ceiling in some states' UMIFA provisions and charitable endowment practices, rather than to the percentage safe harbor listed in Principal and Income Act statutes and the practices of its peers in applying the power to adjust. The trustee appropriates \$25,000 from the appreciation of the corpus and distributes this amount to the beneficiaries in addition to the \$20,000 of trust accounting income.

Now, let us assume that the charitable trust is classified as a private foundation under federal tax law. In this case, the interplay of the statutes is critical; the private foundation tax compliance statute acts as a floor, setting a minimum distribution even if the trustee chooses to increase the payment under a different statute. Maine's private foundation tax compliance statute will allow the trustee to distribute the precise amount—and not a dollar more or less—that the trust needs to avoid penalty taxes under section 4942 of the Internal Revenue Code. We will assume that there is nothing complicating the section 4942 calculation this year and that the minimum distribution requirement is 5%: \$50,000. The trustee is able to distribute \$30,000 from the principal in addition to the \$20,000 of trust accounting income to the income beneficiaries.

As our hypothetical shows, the legislative approach the trustee uses to alter the payment to the income beneficiaries determines whether there is a range of possible distribution amounts or one set figure. Whereas some options (the power to adjust and UMIFA) offer a flexible range, other options (unitrust and private foundation tax compliance statutes) are more rigid. The power to adjust and UMIFA approaches may result in a different range of distribution amounts because the factors the trustee is considering will vary and it will be comparing itself to a different peer group. The chart below shows the facts of our hypothetical, including the high and low ranges available under each approach and the amount our fictional trustee actually chose.



Note that there is a good deal of overlap in the payment range attainable under the four separate statutes. The trustee could have decided upon a distribution of \$50,000 under the adjustment power, the private foundation tax compliance statute, or UMIFA. It could have decided upon a distribution of \$40,000 under the adjustment power, the unitrust, or UMIFA. It is also interesting to note that the trustee is more likely to distribute a greater amount from the charitable trust than from the private trust. Although the trust's tax-exempt status has some effect on the decision, it does not totally account for the disparity. Why is a trustee more likely to spend a higher percentage from a trust that was probably intended to survive over a longer time span? One possibility is that in the context of a charitable trust there is an acceptance that the duty to protect principal does not necessarily include a duty to protect against the effects of inflation.²⁴⁷

Most states do not offer their trustees all of these legislative approaches, but many states offer more than one, particularly for charitable trusts. Trustees must consider not only what amount of additional income would be fair, but also what statutory approach best enables the trustee to reach that goal. Careful trustees who wish to document their discretionary distribution choices may wish to use a checklist of factors that should be considered under the applicable statute. Because these factors vary somewhat, a trustee must be thoughtful in selecting its approach and insure that its actions are consistent with the statute it is relying upon, even though the same dollar distribution could possibly be reached under a different statute.

IV. Changes for the Future

When looking at the variety of statutes available that enable a trustee to balance the entitlements of future and present interests, a few points are striking. First, trust law has come a long way in a short time, but some states lag dramatically behind their peers in enacting legislation necessary to empower their trustees. Second, UMIFA offers unique opportunities to a small class of trusts, but that class may be—and should be—expanding.

The speed at which some states have adopted enabling legislation is surprising. Trust law is generally more of a marathon than a sprint, but in this case many states have been prompt to enact legislation that allows trustees to keep up with modern investment ideals. The current version of the Uniform Principal and Income Act was made final in 1997, and, in less

247. Haskell, *supra* note 25, at 93.

than seven years, the vast majority of U.S. jurisdictions have enacted it.²⁴⁸ Unitrust statutes, which are younger still, have already swept across seventeen states.²⁴⁹ The Uniform Management of Institutional Funds Act also continues to expand, extending its reach to non-institutional trustees in the current draft and in several state statutes.²⁵⁰ Although the development of trust law on this subject has been uncharacteristically rapid, it has not yet reached its full maturity.

As striking as the rapidity of progress of uniform acts and of some state legislatures to develop enabling statutes is the stark contrast with states that have done little or nothing to provide several alternatives. Some states, like Maine, allow trustees a generous menu of tools to balance beneficiary interests. Trustees have the flexibility they need to choose the approach best suited for a particular trust. Other states, like Massachusetts, offer no statutory solutions for non-charitable trustees.

The difference in the availability of options leads to forum shopping. Trustees managing trusts in jurisdictions without necessary legislation are examining the terms of their documents to determine if a change in situs is available at the prompting of sophisticated beneficiaries. States that do not wish to lose trust accounts (and the fiduciary taxes they pay) to other states should enact legislation to put them on a par with their peers.

States in particular should focus on extending the reach of UMIFA to non-institutional trustees, as suggested in the 2004 Draft UMIFA. UMIFA and the power to adjust under the Uniform Principal and Income Act have much in common. They both allow a trustee to distribute either more or less than strict trust accounting income. They both provide a similar list of factors to consider in deciding how much to distribute. They both enable a trustee to invest for total return without sacrificing the current needs of the income beneficiary. UMIFA, however, has been tried and tested over the past several decades, and therefore has allowed guidance to develop on the boundaries of the rule. Institutions are familiar with its rules and can cooperate with their third party trustees to develop an effective endowment management approach. The charities benefit from the flexibility of the statute and its facilitation of total return investing, regardless of whether they are the trustees themselves or whether a third party manages the fund for their benefit.

Consideration might also be given to extending some of the concepts

248. *See infra* app. A.

249. *See infra* app. B.

250. *See infra* app. C; ME. REV. STAT. ANN. tit. 18-A, § 4100; N.H. REV. STAT. ANN. § 292-B.

of UMIFA to non-charitable trusts. The distinction in treatment of charitable and non-charitable trusts may have arisen in part because charitable trusts were often intended to be perpetual, while personal trusts were bound by the rule against perpetuities. As the rule against perpetuities erodes and dynasty trusts increase in popularity, however, it is more common for personal trusts to share the goal of endurance that charitable trusts have historically held.²⁵¹ The concept of making such distributions as are prudent with the long-term survival of the fund—and perhaps the technique of capping distributions with reference to historic dollar value—may be useful in a private trust setting.

Not all of the progress need be legislative. As the creators of trust documents, drafting attorneys are in a unique position to make the best possible use of the tools available for enabling flexibility in distributions. Attorneys in states without helpful statutes should consider analogizing to other states' Principal and Income Act, unitrust statute, or UMIFA provisions.

Conclusion

Trustees in every state should have access to a wide menu of statutory options for balancing the needs of trust beneficiaries. Trust law is rapidly catching up with modern investment practices and theories. As it does, trustees should be granted the tools they need to master the delicate task of pleasing current and future trust beneficiaries. A wide range of statutory techniques for balancing the financial interests of trust beneficiaries allows trustees to rise to the challenge of being fair and reasonable.

²⁵¹. See *Building Your Own Dynasty—States Toss Out Restrictions On Creating Perpetual Trusts; Downside—Fees Last Forever, Too*, WALL ST. J., Sept. 15, 2004, at 1.

APPENDIX A**States That Have Enacted the Uniform Principal and Income Act (1997)—As Listed in Uniform Laws Annotated***

Jurisdiction	Laws	Effective Date	Statutory Citation
Alabama	2000, Act 675	1-1-2001	Code 1975, §§ 19-3A-101 to 19-3A-605.
Alaska	2003, c. 145	9-1-2003	AS §§ 13.38.200 to 13.38.990.
Arizona	2001, c. 176	1-1-2002	A.R.S. §§ 14-7401 to 14-7431.
Arkansas	1999, Act 647	1-1-2000	A.C.A. §§ 28-70-101 to 28-70-605.
California	1999, c. 145	1-1-2000	West's Ann. Cal. Probate Code §§ 16320 to 16375.
Colorado	2000, c. 257	7-1-2001	West's C.R.S.A. §§ 15-1-401 to 15-1-434.
Connecticut	1999, P.A.	1-1-2000	C.G.S.A. §§ 45a-542 to 45a-542ff.
District of Columbia	2001, D.C. Law 13-292	4-27-2001	D.C. Official Code, 2001 Ed. §§ 28-4801.01 to 28-4806.02.
Florida	2002, c. 42	1-1-2003	West's F.S.A. §§ 738.101 to 738.804.
Hawaii	2000, c. 191	7-1-2000	HRS §§ 557A-101 to 557A-506.

* UNIF. PRINCIPAL & INCOME ACT REFERENCES & ANNOTS. (West Supp. 2004), 7B U.L.A. 131 (1997). Given the Principal and Income Act's continuing progress in many jurisdictions, print lists become outdated quickly. To determine whether a state has enacted the 1997 Uniform Principal and Income Act, visit the website of the National Conference of Commissioners on Uniform State Laws at <http://www.nccusl.org/Update/DesktopDefault.aspx?tabindex=3&tabid=60>. See also LEIMBERG & LECLAIR, *supra* note 108.

Idaho	2001, c. 261	7-1-2001	I.C. §§ 68-10-101 to 68-10-605.
Indiana	2002, c. 84	1-1-2003	West's A.I.C. §§ 30-2-14-1 to 30-2-14-44
Iowa	1999, H.F. 584	7-1-1999	I.C.A. §§ 637.101 to 637.701.
Kansas	2000, c. 61	7-1-2000	K.S.A. §§ 58-9-101 to 58-9-603.
Maine	2002, c. 544	1-1-2003	18-A M.R.S.A. §§ 7-701 to 7-773.
Maryland	2000, c. 292	10-1-2000	Code, Estates and Trusts, §§15-501 to 15-530.
Minnesota	1969, c. 1006	1-1-1970	M.S.A. §§ 501B.59 to 501B.76.
Missouri	2001, H.B. 241	7-10-2001**	V.A.M.S. §§ 469.401 to 469.467.
Montana	2003, c. 506	4-25-2003**	MCA §§ 72-34-421 to 72-34-453.
Nebraska	2001, LB 56	9-1-2001	R.R.S.1943, §§ 30-3116 to 30-3149.
Nevada	2003, c. 355	10-1-2003	NRS 164.700, 164.780 to 164.925.
New Jersey	2001, c. 212	1-1-2002	N.J.S.A. 3B:19B-1 to 3B:19B-31.
New Mexico	2001, c. 113	7-1-2001	NMSA 1978, §§ 46-3A-101 to 46-3A-603.
New York	2001, c. 243	1-1-2002	McKinney's EPTL 11-A-1.1 to 11-A-6.4.
North Carolina	2003, c. 232	1-1-2004	G.S. §§ 37A-1-101 to 37A-6-602.
North Dakota	1999, c. 532	8-1-1999	NDCC 59-04.2-01 to 59-04.2-30.
Ohio	2002, No. 186	12-9-2002	R.C. §§ 1340.40 to 1340.91.
Oklahoma	1998, c. 115	11-1-1998	60 Okl.St. Ann. §§ 175.101 to 175.602.
Oregon	2003, c. 279	6-10-2003**	ORS 116.007,

			129.200 to 129.450.
Pennsylvania	2002, c. 50	5-16-2002**	20 Pa.C.S.A. §§ 8101 to 8191.
South Carolina	2001, c. 80	7-18-2001	Code 1976, §§ 62-7-401 to 62-7-432.
Tennessee	2000, c. 829	7-1-2000	T.C.A. §§ 35-6-101 to 35-6-602.
Texas	2003, c. 659	1-1-2004	V.T.C.A. Property Code §§ 116.001 to 116.206.
Virginia	1999, c. 975	1-1-2000	Code 1950, §§ 55-277.1 to 55-277.33.
Washington	2002, c. 345	1-1-2003	West's RCWA 11.104A.001 to 11.104A.905.
West Virginia	2000, c. 273	7-1-2000	Code, 44B-1-101 to 44B-6-604.
Wyoming	2001, c. 11	7-1-2001	Wyo.Stat.Ann. §§ 2-3-801 to 2-3-834.

** Date of Approval.

APPENDIX B**States That Have Enacted Unitrust Statutes***

State	Statute
Alaska	ALASKA STAT. § 13.38.200 (Michie 2004).
Colorado	COLO. REV. STAT. 15-1-402 (2003).
Delaware	DEL. CODE ANN. tit. 12, § 3527 (2004).
Florida	FLA. STAT. § 738.1041 (West 2004).
Illinois	760 ILL. COMP. STAT. § 5 (2004).
Iowa	IOWA CODE § 637-101 (2003).
Kentucky	KY. REV. STAT. ANN. § 386.454 (Banks-Baldwin 2004).
Maine	ME. REV. STAT. ANN. tit. 18-A, § 7-704 (2003).
Maryland	MD. COM. LAW CODE ANN., ch. 478 § 15-501 (2004).
Missouri	MO. REV. STAT. § 469.411 (2004).
New Hampshire	N.H. REV. STAT. ANN. §564-A:3-C (2004).
New York	N.Y. EST. POWERS & TRUSTS LAW §11-2.1 (McKinney 2004).
North Carolina	N.C. GEN. STAT. § 37A-1-101 (2004).
Pennsylvania	20 PA. CONS. STAT. ANN. § 8101 (West 2004).
South Dakota	15 S.D. CODIFIED LAWS § 55-15-1 (Michie 2004).
Virginia	VA. CODE ANN. § 55-277.40 (Michie 2004).
Washington	WASH. REV. CODE § 11.101 (2004).

* Created with reference to <http://www.leimberg.com/freeResources/truStates.asp#ma>. Given the continuing progress of unitrust statutes in many jurisdictions, print lists become outdated quickly. See LEIMBERG & LECLAIR, *supra* note 108 and accompanying text.

APPENDIX C**States That Have Enacted the Uniform Management of Institutional Funds Act (1972)—As Listed in Uniform Laws Annotated***

Jurisdiction	Laws	Effective Date	Statutory Citation
Alabama	1993, 1st Ex. Sess. No. 93-899	8-31-1993	Code 1975, §§ 16-61A-1 to 16-61A-8.
Arkansas	1992, No. 70	3-20-1992	A.C.A. §§ 28-69-601 to 28-69-611.
California	1973, c. 950	9-30-1973	West's Ann. Cal. Probate Code §§ 18500 to 18509.
Colorado	1973, c. 126		West's C.R.S.A. §§ 15-1-1101 to 15-1-1109.
Connecticut	1973, P.A. 73-548	7-1-1973 6-11-1973	C.G.S.A. §§ 45a-526 to 45a-534.
Delaware	1974, c. 572	7-29-1974	12 Del.C. §§ 4701 to 4708.
District of Columbia	D.C.Laws No. 1-103	4-6-1977	D.C. Official Code, 2001 Ed. §§ 44-1601 to 44-1609.
Georgia	1984, p. 831	3-28-1984	O.C.G.A. §§ 44-15-1 to 44-15-9.
Hawaii	1995, Act 46	4-25-1995	H R S §§ 517D-1 to 517D-11.
Idaho	1996, c. 405	7-1-1996	I.C. §§ 33-5001 to 33-5008.
Illinois	1973, P.A. 78-866	10-1-1973	S.H.A. 760 ILCS 50/1 to 50/10.
Indiana	P.L. 268-	4-26-1989**	West's A.I.C. 30-2-

* UNIF. MGMT. OF INSTITUTIONAL FUNDS ACT § 1, 7A U.L.A. 233 (West Supp. 2004) (table of jurisdictions).

** Date of Approval.

	1989		12-1 to 30-2-12-13.
Iowa	1990, S.F.2350	3-29-1990**	I.C.A. §§ 540A.1 to 540A.9.
Kansas	1973, c. 226	7-1-1973	K.S.A. 58-3601 to 58- 3610.
Kentucky	1976, c. 115	6-19-1976	KRS 273.510 to 273.590.
Louisiana	1976, No. 410	7-31-1976**	LSA-R.S. 9:2337.1 to 9:2337.8.
Maine	1993, c. 371	6-16-1993**	13 M.R.S.A. §§ 4100 to 4110.
Maryland	1973, c. 838	7-1-1973	Code, Estates and Trusts, §§ 15-401 to 15-409.
Massachusetts	1975, c. 886	1-17-1976**	M.G.L.A. c. 180A, §§ 1 to 11.
Michigan	1976, P.A. 157	6-17-1976	M.C.L.A. §§ 451.1201 to 451.1210.
Minnesota	1973, c. 313	8-1-1973**	M.S.A. §§ 309.62 to 309.71.
Mississippi	1998, c. 417	7-1-1998	Code 1972, §§ 79-11- 601 to 79-11-617.
Missouri	1976, p. 745		V.A.M.S. §§ 402.010 to 402.060.
Montana	1973, c. 389	3-20-1973**	MCA 72-30-101 to 72-30-207.
Nebraska	1996, L.B. 973	3-19-1996**	R.R.S. 1943, §§ 58- 601 to 58-609.
Nevada	1997, c. 281	7-3-1997	N.R.S. 164.500 to 164.630.
New Hampshire	1973, c. 547:1	9-1-1973	RSA 292-B:1 to 292- B:9.
New Jersey	1975, c. 26	3-5-1975	N.J.S.A. 15:18-15 to 15:18-24.
New Mexico	1997, c. 199	7-1-1997	NMSA 1978, §§ 46-9- 1 to 46-9-12.
New York	1978, c. 690	7-25-1978	McKinney's N-PCL, §§ 102, 512, 514, 522.
North	1985, c. 98	7-1-1985	G.S. §§ 36B-1 to 36B-

Carolina			10.
North Dakota	1975, c. 182	7-1-1975	NDCC 15-67-01 to 15-67-09.
Ohio	1975, p. 303	11-26-1975	R.C. §§ 1715.51 to 1715.59.
Oklahoma	1992, c. 131	9-1-1992	60 Okl.St. Ann. §§ 300.1 to 300.10.
Oregon	1975, c. 707	9-13-1975	ORS 128.310 to 128.355.
Rhode Island	1972, c. 260	5-4-1972	Gen.Laws 1956, §§ 18-12-1 to 18-12-9.
South Carolina	1990, Act No. 390	7-1-1990	Code 1976, §§ 34-6-10 to 34-6-80.
Tennessee	1973, c. 177	5-7-1973	T.C.A. §§ 35-10-101 to 35-10-109.
Texas	1989, c. 213	5-26-1989	V.T.C.A. Property Code, §§ 163.001 to 163.009.
Utah	1997, c. 242	5-5-1997	U.C.A. 1953, 13-29-1 to 13-29-8.
Vermont	1973, No. 59	7-1-1973	14 V.S.A. §§ 3401 to 3407.
Virginia	1973, c. 167	3-10-1973**	Code 1950, §§ 55-268.1 to 55-268.10.
Washington	1973, c. 17	6-7-1973**	West's RCWA 24.44.010 to 24.44.900.
West Virginia	1979, c. 60	6-8-1979	Code, 44-6A-1 to 44-6A-8.
Wisconsin	1975, c. 247	5-15-1976	W.S.A. 112.10.
Wyoming	1991, c. 75	7-1-1991	Wyo.Stat. Ann. §§ 17-7-201 to 17-7-205.

APPENDIX D

States That Have Enacted Private Foundation Tax Compliance Statutes—As Recognized by the IRS in Revenue Ruling 75-38*

“January, 1975

Private foundations; governing instruments; State laws enacted. States that have adopted legislation satisfying the requirements of section 508(e) of the Code, relating to private foundation governing instruments, are listed; Rev. Rul. 73-286 superseded.

The purpose of this Revenue Ruling is to identify those States that have been held by the Internal Revenue Service to have adopted legislation satisfying the requirements of section 508(e) of the Internal Revenue Code of 1954, relating to private foundations.

Under section 508(e) of the Code, a private foundation (as defined in section 509) is not exempt from Federal income tax under section 501(a) unless its governing instrument contains certain provisions. These provisions, generally, must require or prohibit, as the case may be, the foundation to act or refrain from acting so that it will not be liable for the taxes imposed by sections 4941, 4942, 4943, 4944, and 4945.

Section 1.508-3(d) of the Income Tax Regulations provides that a private foundation's governing instrument is deemed to conform with the requirements of section 508(e) of the Code if valid provisions of State law have been enacted which:

- (1) Require it to act or refrain from acting so as not to subject the foundation to the taxes imposed by sections 4941 (relating to taxes on self-dealing), 4942 (relating to taxes on failure to distribute income), 4943 (relating to taxes on excess business holdings), 4944 (relating to taxes on investments which jeopardize charitable purpose), and 4945 (relating to taxable expenditures), or
- (2) Treat the required provisions as contained in the foundation's governing

* Rev. Rul. 75-38, 1975-1 C.B. 161.

instrument.

The States listed below have enacted statutory provisions that satisfy the requirements of section 508(e) of the Code. Therefore, the governing instruments of private foundations under the jurisdiction of these States are generally considered to have been amended as required by section 508(e). However, provisions of these statutes vary widely. For this reason, the notations following the State listing are important.

ALABAMA—except where otherwise provided by a decree of a court of competent jurisdiction or by a provision in the private foundation's governing instrument which in either case has been entered or made after October 1, 1971, and expressly limits the applicability of State law.

ALASKA—except for such private foundations which expressly provide in their governing instruments that the applicable sections of Alaska law do not apply to them.

ARKANSAS—except for such private foundations which expressly provide in their governing instruments that the applicable sections of Arkansas law do not apply to them and except in the case of trusts where otherwise provided by decree of a court of competent jurisdiction.

CALIFORNIA—except where otherwise provided by a court of competent jurisdiction.

COLORADO—with respect to trusts that are private foundations except where otherwise provided by a court of competent jurisdiction.

CONNECTICUT—except where otherwise provided by a court of competent jurisdiction.

DELAWARE—except for such private foundations which expressly provide in their governing instruments that the applicable sections of Delaware law do not apply to them.

DISTRICT OF COLUMBIA—except for such corporations which expressly provide in their governing instruments that the applicable sections of District of Columbia law do not apply to them and except in the case of trusts where otherwise provided by a court of competent jurisdiction. (For purposes of this statute, corporations include corporations organized under any Act of Congress applicable to the District of Columbia as well as corporations organized under the laws of the District of Columbia.)

FLORIDA—except for such trusts which file a proper election not to be subject to the applicable provisions of Florida law and for such corporations as to which a court of competent jurisdiction has otherwise determined.

GEORGIA—except for such private foundations which file a proper

election not to be subject to such law.

HAWAII—no exceptions.

IDAHO—except for such private foundations which expressly provide in their governing instruments that the applicable sections of Idaho law do not apply to them.

ILLINOIS—except for such corporations which have express provisions to the contrary in their articles of incorporation and except for trusts where it is otherwise provided by a court of competent jurisdiction.

INDIANA—except where otherwise determined by a court of competent jurisdiction with respect to private foundations organized before January 1, 1970.

IOWA—except for such private foundations which expressly provide in their governing instruments that the applicable sections of Iowa law do not apply to them.

KANSAS—except where otherwise provided by a court of competent jurisdiction.

KENTUCKY—except, with respect to corporations in existence on July 1, 1972, to the extent that such a corporation provides to the contrary by amendment to its articles of incorporation adopted after July 1, 1972, and, with respect to trusts in existence on July 1, 1972, where action is properly commenced on or before December 31, 1972, in a court of competent jurisdiction to excuse the trust from compliance with the requirements of section 508(e) of the Code.

LOUISIANA—except for such private foundations which expressly provide in their governing instruments that the applicable sections of Louisiana law do not apply to them.

MAINE—except where otherwise provided by a court of competent jurisdiction.

MARYLAND—except where otherwise provided by a court of competent jurisdiction.

MASSACHUSETTS—except where otherwise provided by a court of competent jurisdiction.

MICHIGAN—with respect to trusts that are private foundations except for such private foundations which file a notice of inconsistency under Michigan law.

MINNESOTA—except for private foundations that have been held by a court of competent jurisdiction not to be affected by such State statute.

MISSISSIPPI—except where otherwise provided by a court of competent jurisdiction.

MISSOURI—except for private foundations that have been held by a

court of competent jurisdiction not to be affected by such State statute.

MONTANA—except in the case of trusts where otherwise provided by court decree entered after March 28, 1974, and except in the case of a corporation which has an express provision to the contrary in its articles of incorporation.

NEBRASKA—except for such trusts which effectively elect to be excluded from the applicable sections of Nebraska law, for such corporations which have governing instruments expressly providing to the contrary, and except as a court of competent jurisdiction has otherwise determined in any given case.

NEVADA—no exceptions.

NEW HAMPSHIRE—except where it is otherwise provided by a court of competent jurisdiction.

NEW JERSEY—except for such private foundations which expressly provide in their governing instruments that the applicable sections of New Jersey law do not apply to them.

NEW YORK—except where such law conflicts with any mandatory direction of an instrument by which assets were transferred prior to June 1, 1971, and such conflicting direction has not been removed legally.

NORTH CAROLINA—except for such private foundations which expressly provide in their governing instruments that the applicable sections of North Carolina law do not apply to them and except for trusts that have their governing instruments reformed by a decree of the Superior Court of North Carolina.

NORTH DAKOTA—with respect to trusts that are private foundations except where otherwise provided by a court of competent jurisdiction.

OHIO—except in the case of trusts where it is provided otherwise by a court of competent jurisdiction and except in the case of corporations in existence on September 17, 1971, which expressly adopt contrary provisions in their governing instruments after September 17, 1971.

OKLAHOMA—except for such private foundations which file a proper election not to be subject to such law.

OREGON—no exceptions.

PENNSYLVANIA—except where otherwise provided by a court of competent jurisdiction.

RHODE ISLAND—except where otherwise provided by a court of competent jurisdiction.

SOUTH CAROLINA—except for private foundations which expressly provide in their governing instruments that the applicable sections of South Carolina law do not apply to them.

SOUTH DAKOTA—except where otherwise provided by a court of competent jurisdiction.

TENNESSEE—except where otherwise provided by a court of competent jurisdiction.

TEXAS—except for such private foundations which file a proper election not to be subject to such law.

UTAH—with respect to trusts that are private foundations except where otherwise provided by a court of competent jurisdiction.

VERMONT—except where otherwise provided by a court of competent jurisdiction.

VIRGINIA—except for private foundations whose governing instruments contain express provisions to the contrary or which have filed a proper election not to be subject to such law.

WASHINGTON—except for such private foundations which expressly provide in their governing instruments that the applicable sections of Washington law do not apply to them.

WEST VIRGINIA—with respect to trusts that are private foundations except for such trusts which provide in their governing instruments that the applicable sections of West Virginia law do not apply to them.

WISCONSIN—except as may otherwise be provided by decree of a court of competent jurisdiction.

WYOMING—except where otherwise provided by a court of competent jurisdiction.

Rev. Rul. 73-286, 1973-2 C.B. 188 is hereby superseded.”