ACTEC JOURNAL

THE AMERICAN COLLEGE OF TRUST AND ESTATE COUNSEL

3415 S. Sepulveda Boulevard, Suite 330 • Los Angeles, California 90034 • (310) 398-1888 • Fax: (310) 572-7280 • www.actec.org

Susan T. Bart, Editor / M. Read Moore, Assistant Editor /

Table of Contents

Volume 32, No. 1, Summer 2006

Requests for 2007-2008 Committee Appointments

Interested in committee membership in the coming year? Whether as a new member or as a continuing member, you will need to contact President-Elect Danny Markstein with your interest no later than October 23, 2006.

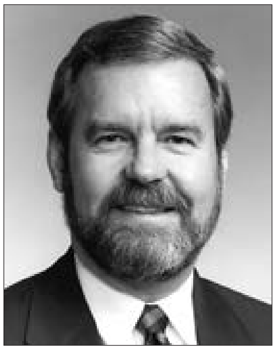
Information on all of ACTEC's committees can be found inside this issue. To request an appointment, you may log on to the private side of the ACTEC website and submit an online committee appointment request (contact Bill Crawford at wlcrawford@actec.org if you need a user name and password), or complete and submit the committee appointment request form that accompanies this issue of the *ACTEC Journal*.

ACTEC's committees are one of the great engines that drive the work of the College, and we want committee members who will actively participate in the work of the committees.

We encourage you to submit your request today!

President's Message

by Bruce S. Ross
Los Angeles, California



Greetings! and welcome to this, my first President's Message, since I was passed the gavel by Immediate Past President Judy McCue. I continue to be amazed at the incredible continuity in leadership ACTEC has achieved over the years due to the consistently strong efforts and leadership exhibited by my predecessors. Judy was no exception, and I will do my level best to live up to the high quality of her strong and quietly determined leadership.

As always, ACTEC has much on its plate to be accomplished in the new 2006-2007 year. I expect great things from each and all of our committees, many headed by old hands and others by extremely well qualified, newly named Chairs (about each of whom you will read elsewhere in this *Journal*). I am counting on our State Chairs to provide personal leadership in each of their respective states, scouring the profession for the "best and brightest" of our profession who deserve consideration for election to ACTEC. And I, President-elect Danny Markstein, and several of our other Officers look forward to meeting personally with many of our Fellows at various upcoming state and regional meetings (a full schedule of which is detailed elsewhere in this issue).

In addition to the camaraderie that greets the visiting Officers and spouses at these meetings, I am always impressed at the consistently high quality of the educational presentations sponsored by our state organizations. Please remember that these meetings provide excellent opportunities for showcasing potential speakers at our national meetings. I am sure Vice President Bjarne Johnson, and his successor, Treasurer Dennis Belcher, will welcome suggestions for speakers at our upcoming national programs.

I have recently advised all of the State Chairs and am pleased to announce here that I have established a new committee whose goal will be to welcome all new Fellows to membership in the College and to welcome all first-time attendees at each of our national meetings. (I don't have a title for this committee yet and offer a free, personalized, hardbound copy of the *ACTEC Commentaries* to the first person who comes up with a first-rate name.) Our Immediate Past President, Judy McCue, has graciously agreed to chair this committee, which will be comprised of Regents named on an ad hoc basis. The objective will be to ask a Regent from the state (or near the state) of the new Fellow or first-time attendee to make telephonic contact and, in the case of a first-time attendee at a national meeting, to share a meal or event or two with the first-time attendee and his or her spouse.

Speaking of which, please make plans to attend one or more of our national meetings this ACTEC year. All will feature the usual great substantive committee meetings, lively and informative programs, interesting tours and special social get-togethers. We begin in Los Angeles from July 6th through the 9th (with a one-day Catalina Island tour pre-dating the meeting on July 5th and a two-day tour of some of Pasadena's great museums and gardens on July 9th and 10th, immediately following the conclusion of the meeting). Both Carol and I were born and raised in Los Angeles, and we are really excited about showing you some of the exciting venues LA has to offer, both the well-known and the hidden secrets. We love LA! and, after our summer meeting, we promise you will too.

Come this fall, we head for Providence from October 12th through the 16th (preceded by a three-day informal get-together for interested Fellows and their spouses/guests in scenic Newport, birthplace of the America's Cup and home to the International Tennis Hall of Fame, among other claims to fame). Much will be accomplished at our fall meeting as well. In particular, we expect the Regents to receive and debate the final report of the Strategic Planning Task Force, capably headed by Co-Chairs Kathleen Sherby (St. Louis, Missouri) and John McDonnell (Oakland, California).

In addition, I expect a report from the Arbitration Task Force under the strong leadership of Bob Goldman (Naples, Florida).

During the year, Past President Carlyn McCaffrey (New York, New York) will continue to guide the efforts of the Circular 230 Task Force as it responds to the recent IRS revisions to Circular 230 and helps rationalize the profession's response to these groundbreaking challenges proposed by Treasury to tax practices generally.

We conclude the 2006-2007 meeting year at the new and highly regarded Westin Kierland Resort & Spa in Scottsdale, Arizona. Scottsdale has consistently been our most popular of annual meeting spots, and we expect 2007's annual meeting to uphold that tradition. Make your plans now to attend our showcase meeting, March 5th (early arrival for Committee members) through March 12th, 2007.

In closing, let me say that I am honored to have been elected to head such a great professional organization. I am pleased to add that my wife, Carol, shares my love for the organization and has exhibited her connections to ACTEC Fellows and spouses in so many ways, all of which will continue throughout 2006-2007. Rest assured I will do everything in my power to keep ACTEC running on a steady course. I hope any Fellow who wishes to will not hesitate to contact me (213.892.4962 or bross@luce.com) with any comments or suggestions as to how I and my colleagues in leadership can better serve the College in the coming year.

Editor's Page

by Susan T. Bart
Chicago, Illinois

This is my first issue as Editor of the *Journal*. Over the past year I have had the pleasure of working as Assistant Editor under Skip Fox. Notwithstanding Skip's sharp intellect, expansive expertise and well-deserved reputation as one of the nation's finest estate planners, Skip never fails to be charming and collegial.

Read Moore, of McDermott Will and Emery, has agreed to be my Assistant Editor for this year and Editor next year. Read frequently writes and speaks on estate planning issues. He brings valuable editorial experience from serving on the editorial board of *Estate Planning* magazine and the *Virginia Law Review.*

With sadness I announce the recent departure of Barbara Ravetti, the ACTEC Publications Manager. Barbara's experience, organization and calm demeanor will be missed. Fortunately for me, Gerry Vogt and Steve Albers, the Business Manager for the College, immediately stepped in to fill the gap created by Barbara's departure. They will soon begin to interview for the position of ACTEC Publications Manager. Please let one of us know if you know of any candidates with strong editorial and organization skills.

This issue is not exactly beach reading. Although generally I prefer shorter articles of ten to thirty pages, this issue contains portions of two extensive articles that are being published in parts in multiple issues of the *Journal.* I wanted to publish these articles in their entireties, notwithstanding their length, because they provide valuable and in-depth analysis of their subjects that is of practical importance to Fellows.

This issue includes part two of a four-part article on fiduciary administration of life insurance by Kathryn A. Ballsun, Patrick J. Collins and Dieter Junkat. This provocative article seeks to shatter our complacency about the traditional manner in which life insurance trusts have been administered and to remind us that fiduciary duties apply as fully to insurance trusts as to any other type of trust. Part one, the appetizer, published in the Spring 2006 issue, discussed the duties of trustees under different models. Part two, in this issue, discusses the application of the prudent investor rule to trusts owning life insurance.

This issue also includes parts one and two of a very timely four-part article by Bob Wolf on Total Return Trusts. Revenue Ruling 2006-26, classifying and expanding upon the rules for qualified terminable interest elections where an interest in an IRA or defined contribution is payable to a marital trust, was issued after Bob's article was typeset and about to go to press. Bob agreed to revise his article, virtually overnight, so that we could include the latest developments on this topic without significantly delaying publication. Bob's article also discusses the final regulations on the definition of "income" and state legislative responses to the final regulations.

I have been delighted by the thoughtful and well-written articles submitted to me and am always on the lookout for excellent articles on topics of interest to Fellows. Please let us know if you are aware of any appropriate articles, whether authored by yourself or others.

Susan T Bart

Total Return Trusts—A Decade of Progress, But Are We There Yet?
(Parts 1 & 2 of 4)

by Robert B. Wolf [*1]
Pittsburgh, Pennsylvania

I. BACKGROUND AND INTRODUCTION

Ten years ago, when the greatest bull market in U.S. stocks had only just begun, this author and Bill Hoisington of California[2] began to write about the critical need to fundamentally reexamine the way we drafted trusts. Despite tremendous changes during the 20th century in how we live and work, there were relatively few changes in the way we drafted trusts, and the majority of those changes were driven by changes in the tax laws. Apart from drafting changes driven by our desire to pursue tax benefits or avoid tax pitfalls, most trusts remained remarkably unchanged in their fundamental directive to hold the principal and distribute the income to the current beneficiary. These traditional trusts, which tell the trustees to hold the principal and pay the income, are subject to a primary distribution rule based on the distinction between principal and income and are referred to in this article as "income rule trusts."

Those who lived through the Great Depression knew the importance of never spending the principal. Even before that, the concept of income came from our agrarian past, in which the "income" was growing crops, and the "principal" was the land itself, and the advice was passed from generation to generation to "never sell the land." And that was good conservative advice that stood the test of time. Without the land, there were no crops, and without the crops, the security of the family, and perhaps even life itself, might be lost.

As time went by, the concept of income as growing crops changed to profits from businesses, and as more and more businesses took on the corporate form, to the dividends from those businesses. So income often came from equity or ownership assets. Income could also come from lending money, in which case the interest on such lending was the "income" on a lending investment asset. And again in that context, as long as only the interest was spent, and the principal were maintained, the means to produce that income was preserved.

A. SO WHAT'S THE PROBLEM?

And in the context of personal saving and trusts, all was well with this distinction that gave the trust the opportunity to provide support in the form of continuing income over a long period of time, perhaps for generations, but it rested upon several key assumptions as it was applied to stocks and bonds:

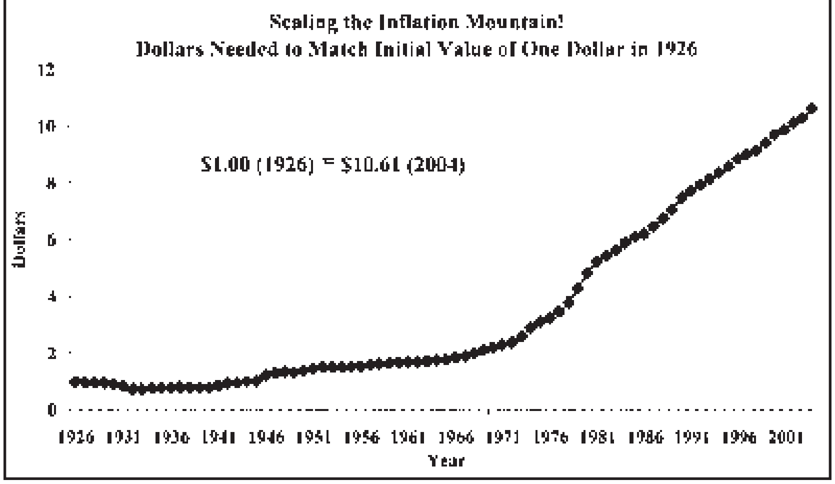
1. With respect to bonds, it assumed that when the bond matured, that the dollars paid back to the trust for reinvestment were worth the same as those when the bond was issued.

2. With respect to equity stocks, it assumed that the dividends from stocks represented a reason-

[1] Partner/Shareholder, Tener, Van Kirk, Wolf & Moore, P.C., Pittsburgh, PA. A.B., Yale University, 1968; J.D., University of Virginia, 1971. This article is the fourth major article written by the author on the topic of trust design for total return. Robert B. Wolf, "Defeating the Duty to Disappoint Equally—The Total Return Trust," 32 *Real Prop. Prob. & Tr. J.* 46 (1997) [another version appeared in 23 *ACTEC Notes* 46 (1997)], "Total Return Trusts—Can Your Clients Afford Anything Less?" 33 *Real Prop. Prob. & Tr. J.* 131 (1998) [another version appeared in 24 *ACTEC Notes* 45 (1998)], and "Estate Planning with Total Return Trusts," 36 *Real Prop. Prob. & Tr. J.* 169 (2001). The author acknowledges and appreciates the substantial contribution of Stephen R. Leimberg, Esquire for his support and insights, and his former associate, J. Dustin Barr, Esquire for his skillful contributions to the author's current computer program used to research these issues and to produce the computer-generated graphs that illustrate this work.

[2] William L. Hoisington, *Modern Trust Design: New Paradigms for the 21st Century,* 5-5, 5-6 (Materials for Miami Institute, Jan. 1997).

GRAPH 1



able payout from the “total return” of those stocks, including both dividends and principal appreciation.

While periodic bouts with inflation occurred in the 19th century and earlier, systemic inflation really only came about during the latter portions of the 20th century. From 1802 to 1870, consumer price inflation averaged only 1/10th of 1%, and from 1870 to 1925, only 6/10th of 1%.[3]

As Graph 1 above illustrates, while there was significant inflation post World War II, real systemic inflation began in the mid- to late 1960s and has been with us ever since.

So, all else aside, a long-term bond might return dollars to the investor that were worth only a very small portion of what they were worth in spending power at the time that the investment was made. Consequently, spending all of the interest received from a bond investment would leave the investor markedly poorer over time.

With respect to stocks, the dividend yield on the Standard & Poor’s 500 Index was once a very good proxy for the income one could spend from stock investments, but over time, dividend yields became smaller and smaller, making this a less and less sensible proxy for “income” on this form of investment, as the the following graph illustrates. *(See Graph 2.)*

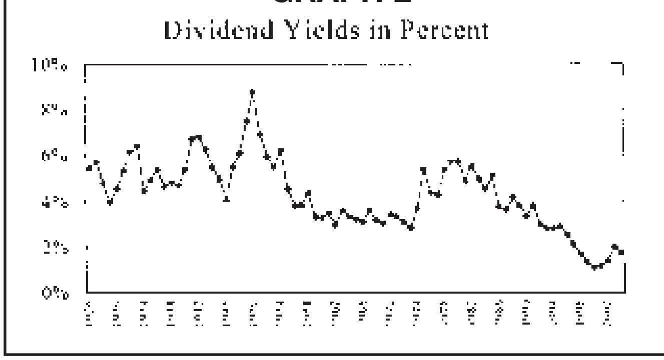
While some of this loss in yield was a result of the great Bull Market of the 1990s and gradually expanding price/earnings ratios, not all of it can be explained that easily. Indeed, the proportion of the reported earnings paid out in dividends appears to have undergone a long-term decline as well. *(See Graph 3.)*

Difficult as it may be to believe, the S & P 500 Index had a dividend yield at the start of the 1950s of almost 9%, while an intermediate Government Bond yielded only 1.4%.[4] There was a reason for that at the time: the need for “safety” in a generation that had seen the bank failures of the 1930s and the Great Depression, but it is a far cry from the investment markets of the last 10 to15 years, in which the trustee was torn between the desire from the income beneficiary to invest in bonds so that she could receive more income, and the desire of the remainder beneficiary to invest in stocks, so that she could profit from more growth, which would not in the ordinary course have been distributed on a current basis.

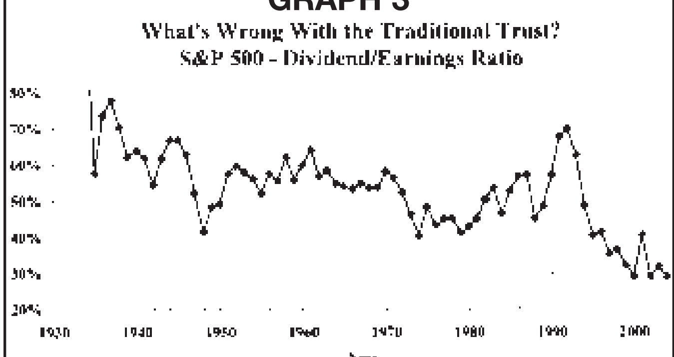
Much of this decline in payout may have been the result of bad tax policy, discussed later, which essentially “punished” a liberal dividend policy with double taxation, a policy that has been significantly reversed as discussed later in this article. But the problem is still very much with us.

The bottom line on the decision of bonds versus stocks actually becomes very clear when we take into account taxes, expenses and inflation. Consider the following series of charts. *(See page 7.)*

GRAPH 2

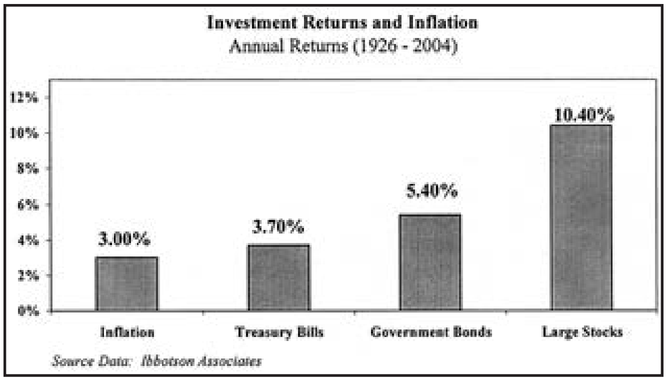


GRAPH 3

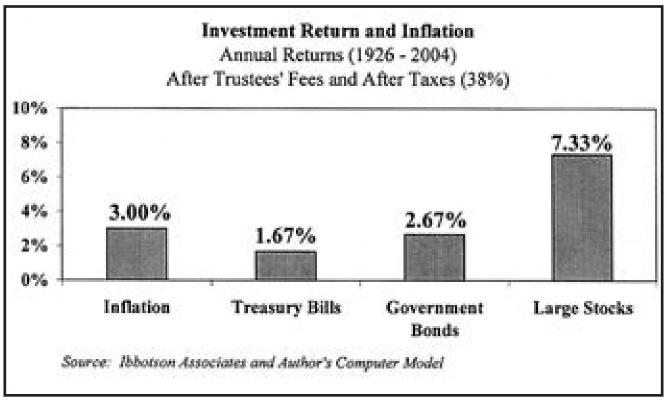


[3] John C. Bogle, *Common Sense on Mutual Funds: New Imperatives for the Intelligent Investor,* 9, 13 (1999), compiled from the research of Professor Jeremy Siegel in J. J. Siegel, *Stocks for the Long Run* (2d ed. 1998).

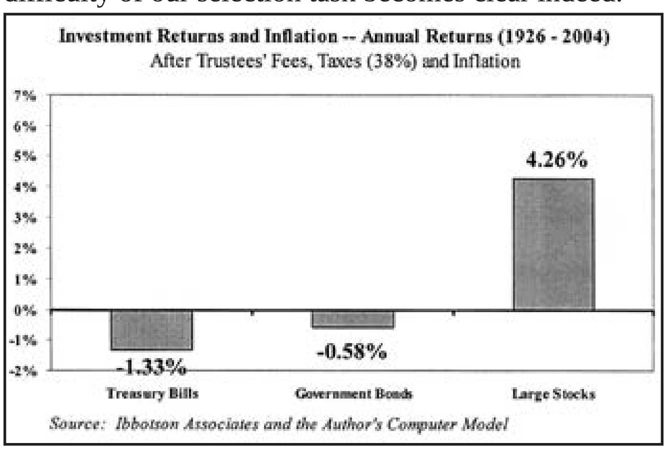
[4] *Ibbotson Associates, Stocks, Bond, Bills, and Inflation 2004 Yearbook* at 226, 244 (2004).



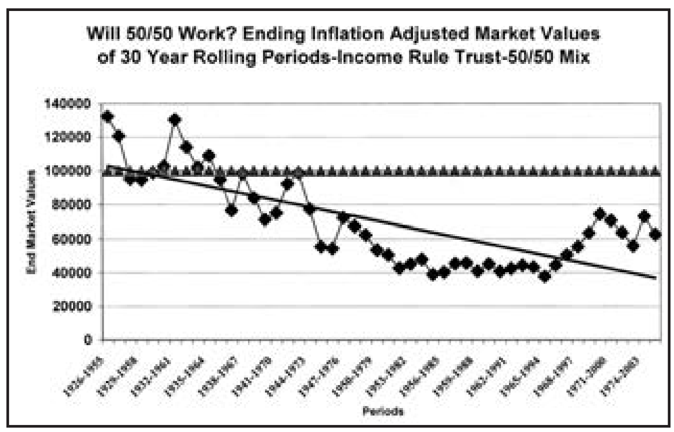
And this all looks pretty rosy until we subtract 1% in trustees' fees and the effects of income taxes on the trust, which, even assuming very low turnover of 5% per year, reduces the return available for the beneficiaries and to offset inflation considerably:



And once we take into account inflation, the difficulty of our selection task becomes clear indeed.



When you combine all of these statistics, it is clear that equity investments in stocks or other investments with a similar return are needed to be able to maintain the value of a long-term trust, but at the same time, with dividend yields still at 1.79% for the S & P 500 Index, clearly a trust invested entirely in equities will not be able to distribute any significant amount of income to the trust beneficiary if the trustee is limited to the traditional definition of income. The gross income on a $1,000,000 trust invested in the S & P 500 Index would be $17,900, and if 1/2 of 1% of the trustee's fees are charged to income, that income would drop to $12,900 per year on a $1,000,000 trust. A "balanced" portfolio of 50% 10 year U. S. Treasury Notes and 50% in the S & P 500 Index would yield about 2.8% on a net income basis, likely not enough income to satisfy the income beneficiary, nor enough growth to satisfy the remainder beneficiaries. Using the author's computer model the assumptions and mechanics of which have been described in prior published materials,[5] the inflation adjusted results of a 50/50 mix of stocks and bonds over long 30-year investment periods is nothing short of disastrous, with the last 30-year period in which the trust would have preserved real value having ended in 1964, the year this author graduated from high school and Barry Goldwater and Lyndon Banes Johnson squared off in a U.S. presidential election!



Since 1964, a trust invested 50/50 in stocks and bonds would have failed to protect the real value of the trust in 40 successive 30-year periods because of the effects of taxes, expenses and inflation. So the coupling of low stock and bond yields with the need to

[5] Fall Meeting of the American College of Trust and Estate Counsel, SI-156-158 RBW (2004). In short, the Standard & Poor's 500 Index is used as a proxy for the equity portion of the trust and the Intermediate U.S. Government Index for the bond portion of the trust portfolio, 1% trustees' fees, a 1% cost roundtrip on turnover, and an index like turnover of 5% for the portfolio is assumed, as well as a cost basis starting at current market value, and ordinary income tax rates of a total of 38% in federal and state income tax and 22% in capital gains tax rates. The current income tax rates, which are more favorable to equity investing, are not used in this analysis in light of the uncertainty of the permanency of those lower rates. A more detailed description of the exact computational methodology is omitted here, as it has already been published on a number of occasions to expose it to critical discussion.

invest mostly in equity stocks or other equity investments, such as real estate or alternative investments with comparable total return, produced a huge problem for investors in general and for trustees of long-term trusts in particular.

Addressing the challenge of investing trust portfolios in a way that acknowledges modern financial theory, the *Restatement (Third) of Trusts* specifically endorsed the use of total return investing and adopted what has come to be known as "modern portfolio theory" where the appropriateness of a trust investment is not viewed in isolation, but rather as its impact on the portfolio as a whole.[6] Shortly thereafter the Uniform Prudent Investor Act was adopted by the National Conference of Commissioners on Uniform State Laws on August 5, 1994. Incorporating modern portfolio theory into the Uniform Prudent Investor Act abrogates all categorical restrictions on types of investments. The trustee can invest "in anything that plays an appropriate role in achieving the risk/return objectives of the trust and that meets the other requirements of prudent investing."[7] Section 2 of the Act also states a number of circumstances that the trustee must consider in investing and managing trust assets:

(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.[8]

In addition, the Act creates an express duty of impartiality in connection with investments in Section 6:

> If a trust has two or more beneficiaries, the trustee shall act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries.[9]

This duty of impartiality implies a shift away from the general favoring of the life income beneficiary, often what the testator might prefer, in favor of an even-handed duty between the current and remainder beneficiaries. In the context of the investment imperatives and the traditional income and principal distinctions, this duty of impartiality increases the tension and burden on the trustee attempting to function in the context of the conventional income rule trust. The Prudent Investor Act or a variation of it has been adopted in some form in the District of Columbia, the U.S. Virgin Islands and 42 states.[10]

B. THE "SOLUTIONS" TO THE PROBLEM.

Primarily two solutions to this thorny problem have arisen and taken hold. The first is integrated into the Revised Uniform Principal and Income Act.

1. The Uniform Principal and Income Act. A third version of a Uniform Principal and Income Act was approved by the National Conference of Commissioners on Uniform State Laws in July 1997. The primary purposes of this newest revision, reflecting six years of labor, was to update the prior Principal and Income Acts, *i.e.*, to recognize new forms of investments, to reflect the modern portfolio theory of investing, and to allow fiduciaries the means for making the best investment decisions to conform with the prudent investor rules in the *Restatement (Third) of Trusts* and in the Uniform Prudent Investor Act.[11]

The Uniform Principal and Income Act reflects acceptance of total return investing and gives

---

6 *Restatement (Third) of Trusts* §227(d)(1990).

7 Unif. Prudent Investor Act, 7B U.L.A. 280, 300 (2000) (prefatory note).

8 *Id.* at 240.

9 *Id.* at 300.

10 *See* Fact Sheets at website for National Conference of Commissioners on Uniform State Laws http://www.nccusl.org/Update/uniformact_factsheets/uniformacts-fs-upria.asp. Alaska, Arizona, Arkansas, California, Colorado, Connecticut, District of Columbia, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Maine, Massachusetts, Maryland, Michigan, Minnesota, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Utah, U.S. Virgin Islands, Vermont, Virginia, Washington, West Virginia, Wisconsin, Wyoming.

11 Unif. Principal and Income Act §104, 7B U.L.A. 131 (2000) (prefatory note).

the trustee the power to reallocate or adjust returns between income and principal under certain circumstances. It has been adopted in the District of Columbia and 40 states.[12]

Section 104 of the Act, titled "Trustee's Power to Adjust," addresses the tension between the duty of impartiality and the duty to give due regard to the interests of both the income and remainder beneficiaries.[13] The critical language of Section 104 reads as follows:

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

> Section 103 of the Act provides that:

> (a) In allocating receipts and disbursements to or between principal and income, and in any matter within the scope of [Articles] 2 and 3, a fiduciary:
>
> (1) shall administer a trust or estate in accordance with the terms of the trust or the will, even if there is a different provision in this [Act];
>
> (2) may administer a trust or estate by the exercise of a discretionary power of administration given the fiduciary by the terms of the trust or the will even if the fiduciary exercises that power in a manner different from a provision of this [Act];
>
> (3) shall administer a trust or estate in accordance with this [Act] if the terms of the trust or the will do not contain a different provision or do not give the fiduciary a discretionary power of administration; and
>
> (4) shall add a receipt or charge a disbursement to principal to the extent that the terms of the trust and this [Act] do not provide a rule for allocating the receipt or disbursement to or between principal and income.
>
> (b) In exercising the power to adjust granted by Section 104(a) or a discretionary power of administration regarding a matter within the scope of this [Act], whether granted by the terms of a trust, a will, or this [Act], a fiduciary shall administer a trust or estate impartially, based on what is fair and reasonable to all of the beneficiaries, except to the extent that the terms of the trust or the will clearly manifest an intention that the fiduciary shall or may favor one or more of the beneficiaries. A determination in accordance with this [Act] is presumed to be fair and reasonable to all of the beneficiaries.

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

The foregoing language allows a trustee to distribute a portion of the total return arising from appreciation of principal by adjusting from principal to income under appropriate circumstances. The Uniform Act also permits accumulation of income under other circumstances to be fair and impartial to both beneficiaries.[14] If the document does not call for impartiality, such as by stating that the welfare of the current beneficiary is of primary importance, the power might be used to best effectuate the intent of the settlor, given the economic conditions and investment alternatives available.

The Uniform Act also strives to preserve the critical tax benefits and to avoid creating any new tax problems, particularly with respect to the marital deduction, by denying the trustee the power to reduce the income interest of a trust that otherwise qualifies for the marital deduction[15] and by denying the power to adjust if possessing it would cause the trust to be included in the estate of the power holder, if it would otherwise not have been so included, or which would impose the grantor trust rules on the trust if they would otherwise not apply,

---

[12] Alabama, Alaska, Arizona, Arkansas, California, Colorado, Connecticut, Florida, Hawaii, Idaho, Indiana, Iowa, Kansas, Kentucky, Maine, Maryland, Michigan, Missouri, Montana, Nebraska, Nevada, New Jersey, New Mexico, New York, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, South Carolina, Tennessee, Texas, Utah, Virginia, Washington, West Virginia, Wisconsin, Wyoming.

[13] Unif. Principal and Income Act, *supra* note 11.

[14] *Id.*

[15] *See Id.* §104(c)(1).

or cause the annual gift tax exclusion on a gift of an income interest to be lost.[16] And the power to adjust would be denied if the source of the deduction were assets permanently set aside for charity, again intended to protect tax benefits.[17] A more detailed discussion of the effects of these protections under the Final Regulations under Section 643 is contained later in this article.

Section 104 of the revised Uniform Principal and Income Act would deny this power to a trustee who is an interested party to such an adjustment, whether the trustee is a beneficiary or otherwise, but would allow a disinterested co-trustee[18] to exercise the power if this approach would eliminate the difficulty.

Finally, the Uniform Act would allow the trustee with a tax concern to release all or part of the power provided by Section 104, either permanently or for a specified period, including a period measured by the life of an individual.[19]

The terms of Section 104 would apply to all trusts that distribute based upon the distinctions between principal and income "unless it is clear from the terms of the trust that the terms are intended to deny the trustee the power of adjustment."[20] It is unlikely that many existing trusts would have such clear language, and hence retroactive applicability is almost universal, except where the application might cause a tax problem, or where the settlor has specifically dealt with the question of how much the current beneficiary is to receive by providing for a unitrust or an annuity interest.[21]

UPAIA and Section 104 reflect a very significant and useful development in the law of trusts. It provides an escape valve when the pressure and inflexibility of our income and principal rules becomes too great. ***But the need for Section 104 itself, after the application of all of the detailed income and principal rules contained in the updated Act, is an implicit recognition that the concept of income and principal, at least as it has been traditionally defined, is a failed concept. It is failed because the concept does not take into account inflation and the need to preserve real value, and because there is no absolute correlation between traditional income and total return.***

2. The Total Return Unitrust ("TRU"). The second solution to the problems encountered by a trustee attempting to invest prudently and distribute fairly is to distribute a percentage of the fair market value of the trust, regardless of whether the payment is made from what is traditionally considered to be principal or what is traditionally considered to be income. This idea is not new, in the sense that it was proposed and discussed in the 1960s,[22] and was adopted in substitution for the more suspect and manipulable traditional notion of "income" for charitable split interest trusts by the 1969 Tax Reform Act, which required either a unitrust and an annuity interest for a charitable deduction to be allowed.[23]

Oddly, though, this relatively simple concept of paying out a percentage of a trust's fair market value in place of income did not catch on for the purely private trust until almost 30 years later. At almost the same time, charitable endowments and foundations were being freed from the chains of the income rule by the Uniform Management of Institutional Funds Act, passed in 1972[24] ("UMIFA"). UMIFA allowed fund managers to utilize a portion of realized or unrealized gain on their investments to supplement traditional income in order to allow their investment managers to invest prudently for total return, including both traditional income and capital gain.[25] The charitable endowment field has long invested and distributed using a total return approach, and perhaps most frequently using a percentage of the market value as a common methodology for determining payout. The most thorough treatment of the development of the law in the charitable and university endowment arena is undoubtedly Professor Dobris' 1993 article on the subject.[26]

---

16 *See Id.* §104(c)(2), (5) and (6).

17 *See Id.* §104(c)(4).

18 *Id.* §104(d).

19 *Id.* §104(e). If the trustee continues to retain some interest in the trust which might make the release a transfer with a retained interest, that trustee would not be able to effectively release a power of appointment considered to be general if the trustee is trying to avoid death tax includability. *See* Rev. Rul. 86-39, 1986-1 C.B. 301. For this reason, a disclaimer qualified under I.R.C. §2518 might be needed within nine months of the creation of the power. *See* I.R.C. §2518 (1997).

20 Unif. Principal and Income Act, *supra* note 11, §104(f).

21 *Id.* §104(c)(3).

22 Robert M. Lovell, "The Unitrust: A New Concept to Meet an Old Problem," *Tr. & Estates*, March 1966, at 215; Del Cotto and Joyce, "Taxation of the Trust Annuity: The Unitrust Under the Constitution and the Internal Revenue Code," 23 *Tax L. Rev.* 257 (1968).

23 CRATs, Charitable Remainder Annuity Trusts, allowed by I.R.C. §664(d)(1); CRUTs, Charitable Remainder Unitrusts, allowed by I.R.C. §664(d)(2); CLATs, Charitable Lead Annuity Trusts, allowed under Treas. Reg. §20.2055-2(e)(2); CLUTs, Charitable Lead Unitrusts, allowed under Treas. Reg. §25.2522(c)-3(c)(2)(vii).

24 Uniform Management of Institutional Funds Act, 7A Part II U.L.A. 475 (1999).

25 A new version of UMIFA is likely within the next year, and the most recent draft considered is available at http://www.law.upenn.edu/bll/ulc/umoifa/2005AMDraft.htm.

26 *See* Joel C. Dobris, "Real Return, Modern Portfolio Theory, and College, University, and Foundation Decisions on Annual Spending from Endowments: A Visit to the World of Spending Rules," 28 *Real Prop. Prob. & Tr. J.* 49 (1993). *See also* Joel C. Dobris, "New Forms of Private Trusts for the Twenty-First Century—Principal and Income," 31 *Real. Prop. Prob. & Tr. J.* 1 (1996).

A unitrust design responds to several important goals in determining how we might construct a distribution rule for the modern trust.

- The trust must enable the trustees to invest for the highest total return consistent with the level of risk acceptable to the trust and its beneficiaries.
- If possible, it should create an identity of interest between the current beneficiary, the trustee and the remaindermen relative to investment decisions.
- It should allocate returns well and fairly in all types of markets, even when there are times of unusual volatility, whether up or down.
- The flow of distributions to the current beneficiary should be as smooth as practicable while maintaining the identity of interest among the parties to the trust.
- The distribution rule should be simple enough for most clients to understand.

For the most part, the unitrust with a three-year smoothing rule addresses all of the foregoing criteria. Its greatest strength is the fact that it creates a true identity of interest between the current income beneficiary on the one hand and the remainder beneficiary on the other. No other method of distribution does this as well as the unitrust. Its greatest weakness is a direct result of its greatest strength. During protracted volatile bear markets, the income beneficiary will suffer right along with the market value of the trust corpus. Its simplicity and predictability makes it much more transparent to the trust beneficiaries, but that very predictability means that the trustee cannot change the distribution method or rate in its discretion.

In short, the Power to Adjust and the Power to Convert to a Unitrust are reverse images of each other and will be best suited to different circumstances, depending upon the identity of and relationship between the trustee, the current beneficiary and the remainder beneficiary.

A great deal has been written about the unitrust, both in scholarly and professional journals[27]

[27] *See* Robert B. Wolf, "Estate Planning with Total Return Trusts," 36 *Real Prop. Prob. & Tr. J.* 169 (2001) ("Wolf 3"); Robert B. Wolf and Stephen R. Leimberg, "Total Return Unitrust: The (TRU) Shape of Things to Come," *Research Institute of America, Estate Planner's Alert* (December 1998); Robert B. Wolf, "Total Return Trusts—Can Your Clients Afford Anything Less," 33 *Real Prop. Prob. & Tr. J.* 131 (1998) (another version appeared in 24 *ACTEC Notes* 45 (1998) ("Wolf 2") and "Defeating the Duty to Disappoint Equally—The Total Return Trust," 32 *Real Prop. Prob. & Tr. J.* 45 (1997) (another version appeared in 23 ACTEC Notes 46 (1997) ("Wolf 1"); William L. Hoisington, "Modern Trust Design: New Paradigms for the 21st Century," 31 U. *Miami Inst. on Est. Plan.* 5-5, 5-6 (1997); Jerold I. Horn, "Prudent Investor Rule, Modern Portfolio Theory, and Private Trusts: Drafting and Administration including the "Give-Me-Five" Unitrust," 33 *Real Prop. Prob. & Tr. J.* 1 (1998); Joel C. Dobris, "Why Five? The Strange, Magnetic and Mesmerizing Effect of the Five Percent Unitrust and Spending Rate on Settlors, Their Advisors and Retirees," 40 *Real Prop. Prob. & Tr. J.* 38 (2005); Joel C. Dobris, "New Forms of Private Trusts for the Twenty-First Century Principal and Income," 31 *Real Prop. Prob. & Tr. J.* 1 (1996); Mark Edwards, "Trusts for the New Century: The Third Paradigm," *The Will and the Way,* No. 1 (November 1998); William L. Hoisington, "Fiduciary Principles, Modern Financial Theory and Practical Implications for Trust Design and Administration," ACTEC 1998 Annual Meeting Symposium (February 1998); Holding and Reid, "The Private Unitrust vs. The Discretionary Trust as a Paradigm for the New Century," *The Will and the Way,* No. 2 (Feb. 1999); Arthur Sherwood, "Tax Aspects of Using a Unitrust Amount to Define Appropriate Benefit Currently Distributable from Non-Charitable Trusts," 70 *New York State Bar Journal* 70 (September/October 1998); Edward Polisher, "From Classic to Innovative—The Total Return Unitrust," *Atlanta Bar Association Section on Taxation Newsletter* (Spring 1999); David A. Diamond, "Trust Design and Investment Strategy for the Next Millennium: Pulling the Plug on Income Rule Trusts," 5 *California Trusts and Estates Quarterly,* No. 3 (Fall 1999); James Garland, "Long Duration Trusts and Endowments," *J. of Private Portfolio Management,* (Spring 2005); James Garland, "The Problem With Unitrusts," *J. of Private Portfolio Management,* (Spring 1999); Harrison Gardner, "The Income-Only Trust: Rest in Peace," 8 *NJL* 1943, September 13, 1999; James Garland, "A Market-Yield Spending Rule Revisited" (Update through 1998); *J. of Private Portfolio Management,* (Winter 1999); Robert B. Wolf, Stephen R. Leimberg, and Susan Porter, "The Total Return Trust (TRU) Revolution—An Introduction," 34 *U. Miami Inst. on Est. Plan.* (2000) ("Wolf Miami"); Robert B. Wolf and Bruce A. Guiot, "Case Study—Total Return Trusts: Techniques and Applications," 34 *U. Miami Inst. on Est. Plan.* (2000); James Dam, "Should Estate Planners Be Revising Their Trusts," 2000 *LWUSA* 101 (February 7, 2000); Jonathan A. Levy, "The Total Return Unitrust: Is it Time for High-Fives?" *Tr. & Estates* (June 2000); James W. Rockwell, "Total Return Trusts," 26th Annual Probate & Trust Law Conference, Minnesota Bar Assn. (June 2, 2000); Michel W. Nelson, "In Support of a Unitrust Distribution Concept, 127th Annual Convention," Iowa State Bar Association, (June 22, 2000); Linda B. Hirschson, "The Unitrust Alternative: A Framework for Total Return Investing," *Tax Management Memorandum,* Vol. 42, No. 23, 483 (Bureau of National Affairs, November 5, 2001); Alvin J. Golden *'Total Return': Is this How Trusts Are to Be Structured in the New Millennium? Can You Afford Not to Recommend Them?* (2000); Edward Jay Beckwith, "Distribution Issues For Substantially Appreciated Trusts—Is It Possible To Provide A Fair Return to both Current And Future Beneficiaries?" SF68 *ALI-ABA* 555 (2001). Lyman W. Welch, "Committee Report: The Fiduciary Professions, Progress of Total Return Legislation," *Tr. & Estates* 12 (December 2001); Patrick J. Collins and Josh Stampfli, "Promises and Pitfalls of Total Return Trusts," 27 *ACTEC Journal* 205 (2001); Barry L. Kohler, "TRU or False, An Introduction to the Total Return Unitrust," *Maine Bar J.* 94, Spring 2001; Lyman W. Welch, "Policy Differences in Total Return Laws," *Tr. and Estates* (June 2001); Richard W. Nenno, "Where the Rubber Meets the Road: Implementing Total Return Trust Statutes," 36 U. *Miami Inst. on Est. Plan.* 1400 (2002); Gerard J. Monchak, "The TRU Debate: The Pros and Cons of Using Total Return Unitrusts," *J. of Financial*

and in the mainstream financial press,[28] but more importantly, into the laws of a great many of our states, to allow traditional income rule trusts to be converted into unitrusts, even after they have become otherwise irrevocable, and recognizing the unitrust concept as an acceptable alternative to the traditional notion of dividends and interest as "income."

II. WHAT'S NEW AND TRU?

A. BORN IN THE U.S.A.—TOTAL RETURN STATUTES TURN THE CORNER DESPITE A BULL TURNING INTO A BEAR.

1. The Engine of Change. Total return statutes, which intend to provide for a definition of income which will permit the trustee to invest prudently and distribute fairly and impartially, are the result of more than a decade of progress in trust thinking. The *Restatement (Third) of Trusts* first forced open the door to modern investment thinking for trusts, and the Uniform Prudent Investor Act gradually found its way into state laws across the country. Once the duty to invest for total return and the duty to invest taking into account an obligation of fairness to both the current beneficiaries and the remainder beneficiaries were in play, the trustee was thrust into a substantial dilemma as to how to invest the trust if the trust provided for the distribution of income and income only on a non-discretionary basis. The Uniform Principal and Income Act with its Section 104 Power to Adjust, discussed earlier in this article and statutory powers to convert income trusts to unitrusts were a necessary and natural reaction to this dilemma. There was one driving force and one triggering event at work during that time. The driving force was the most powerful bull market in history from 1995 through 1999; an unprecedented time of returns for large capitalization U.S. stocks:

Year	Total Return
1995	37.43%
1996	23.07%
1997	33.36%
1998	28.58%
1999	21.04%

Total return over the five-year period was a sizzling 251.04%. Expectations came in two sizes: big and bigger. But the portion of that return that came from dividends during the same period only came in small and extra small:

Year	Dividend Return
1995	2.91%
1996	2.54%
1997	2.11%
1998	1.68%
1999	1.36%

Total return over the five-year period from dividends was a mere 11.05%. So 96% of the return during that period of tremendous bull market was represented by principal appreciation and potential capital gain, and only 4% of the return was represented by the dividends on those equities. Worse yet, those dividends, small as they were, were taxed at rates up to 38% for federal purposes, while long-term capital gains were taxed at 20%. So in an all equity portfolio, the income beneficiary was really suffering while the portfolio market value was growing tremendously. No wonder that trust beneficiaries and investors in general were turning away from dividend income as a significant source of return. This was the engine of change that forced trustees, practitioners and, ultimately, state legislatures to change their income and

Service Professionals (April 2003); Sidney Kess and Martin M. Shenkman, "Total Return Trusts: What Practitioners Should Know," *Estate Planning Review* (May 22, 2003); "Managing Trusts: Better Decisions in An Uncertain World," *Bernstein Wealth Management Research,* June 2003.

[28] *See* "A Welcome New Twist in Trusts," Standard & Poor's Outlook, Feb. 10, 1999, at 8-9; Jan Alexander, "Harmonious Inheritance," *Worth*, December 2001, at 30; Brad Burg, "Will Your Trusts Keep Your Heirs Poor—and Fighting?" *Med. Econ.,* Sept. 18, 2000, at 63; Carrie Coolidge, "In Growth We Trust," *Forbes,* Mar. 8, 1999, at 166; Frank Croke, "Total Chaos," *Fin. Plan.,* May 2000, at 95; Ashlea Ebeling, "New Cash from Old Trusts," *Forbes,* September 17, 2001, at 144; Brian Hindo, "Making Trust Funds Do Double Duty," *Business Week,* April 8, 2002, at 80; Michael L. M. Jordan, "Implementing MPT In an Allocated Total Return Trust," *J. of Fin. Plan.,* June 1998, at 78; Donald J. Horn, "Balancing Act," *Financial Planning Interactive,* September 2003; Lynn O'Shaughnessy, "Seven Trust Trip-Ups," *Mutual Funds,* June 2000, at 88; Barbara Gilder Quint, "How a Unitrust Could Keep the Whole Family Happy," 17 *Physicians Fin. News,* Apr. 15, 1999, at 8, available at http://pediatrics.medscape.com/PFNPublishing/PhysiciansFinancialNews/1999/v17.n5/pfn1705.08.01.html (last visited Jun. 26, 2001); Dan Rottenberg, "Wealth Preservation Liberated Trust," *Bloomberg Pers. Fin.,* 1998, at 101; Rachel E. Silverman, "Can You Trust Mom With Your Trust?" *Wall St. J.,* April 30, 2003; Ruth Simon, "New Laws May Lift Trust-Fund Returns," *Wall St. J.,* July 22, 1999; Grace K. Weinstein, "Untying the Knots of Total Returns," *Financial Times,* July 31, 2001; Robert Lowes, "Haven't Updated Your Estate Plan Lately? Uh-Oh," *Medical Economics II,* November 5, 2001. Donald Jay Korn, "Balancing Act," *Financial Planning Interactive* (September 1, 2003); Marshall Loeb and Brendan January, Protect retirement nest egg by living off 4 percent a year, *Pittsburgh Post-Gazette,* (Feb. 16, 2004); Ashlea Ebeling, "Opening the Income Tap," *Forbes* (Feb. 16, 2004); Suzanne Baillie Schmitt, IRS revises the definition of trust income to reflect changing state law concepts, Leimberg Services (April 2004); Deborah L. Jacobs, Weatherproofing, Bloomberg Wealth Manager (May 2004).

principal laws to provide for some relief, either by adopting the Uniform Principal and Income Act with Section 104 Power to Adjust, or a unitrust conversion statute, or both.

The triggering event was the adoption on February of 2001 of the Proposed Regulations broadening and updating the definition of income for tax purposes, as will be discussed in more detail in the following section of this article.[29] Up to that point in time quite a few states had adopted the Uniform Act, but, while a number of states, notably New York, Missouri, Pennsylvania and Delaware were studying the unitrust alternative, none of them had adopted it, at least in part out of concern that the IRS would not honor a unitrust definition of income, and might disqualify trusts for marital deduction purposes, endanger grandfathering for generation skipping tax purposes, or consider such a conversion to be a gift or a taxable event for income tax purposes. The Proposed Regulations relieved those worries substantially, and kick started a revolution in state legislation.

2. The Broad Brush. On June 21, 2001, Delaware became the first state in the country to enact a statute expressly allowing trustees of income trusts to convert their income trusts to a unitrust. While both New York, which passed its statute the day before Delaware, and Missouri, which passed its statute at the end of May 2001, were ready to put their laws into effect, Delaware's Governor had the quickest pen.[30] New York played a very significant role in critically examining the state law definition of income and issuing a substantial legislative report recommending the adoption of a unitrust definition of income,[31] which lent focus and weight to those arguing for such a change to be considered by state legislatures. The combination of the New York initiative and the IRS acceptance of the unitrust and the power to adjust in its Proposed Regulations led to an explosion of state legislative activity. In the four years since the promulgation of the Proposed Regulations, basically saying that a unitrust definition of income was fine as long as it was pursuant to a state statute, and as long as the percentage specified was between 3 and 5%, a total of 23 states have adopted unitrust legislation, and about the same number of states during that period adopted the Uniform Act and the Section 104 power to adjust. Section 104 of the Uniform Act is now in effect in 40 states.

Today only five states have no form of total return legislation:

Mississippi
North Dakota
Rhode Island
Utah
Vermont

All of the rest of the states have adopted the power to adjust, the power to convert to a unitrust, or both, and the largest number of states that have enacted such legislation since the Proposed Regulations approved both approaches, enacting statutes with both the power to adjust and the power to convert to a unitrust, a total of 19 states to date. This gives those states the richest set of options for the trustee to match the remedy to the situation, the trust assets and the trust beneficiaries. All of this is even more remarkable in light of the fact that the raging bull market turned into a growling bear with the following total returns for the S & P 500 for the years 2000 through 2002:

Year	Total Return
2000	-9.11%
2001	-11.88
2002	-22.10%

Lawyers, trustees, legislators and investors all share the human trait of being influenced by the most recent events, so the fact that the development of the law continued despite the turning of the worm in the markets is a good thing and a sign of the maturity of thought that has gone into the entire process. The law of trusts must change over time with changes that occur in the underlying long-term conditions of the markets, of trustees, settlors and beneficiaries, but not with every twist and turn of the market.

3. Unitrust Statute Models and Trends. While for the most part the states adopting the power to adjust in Section 104 of the Uniform Act did so without many changes to the Uniform Act, the states had no one model to use for a unitrust conversion statutes. They have tended to follow several of the state statutes that were discussed and passed early on in the process; most significantly the statutes of Pennsylvania, Delaware and Illinois.

---

[29] Proposed Reg-106513-00, Fed. Reg., February 15, 2001, Vol. 66, No.32, at 10396-10402 ("Proposed Reg.").

[30] http://www.legis.state.de.us/ The Act amends Title 12 of the Delaware Code, by adding a new section 3527 entitled "Total return unitrusts." Those of you with an historical bent may remember that Delaware has always been quick to act on good ideas, being the first to sign the new United States Constitution as well on December 7, 1787. *See* http://www.legis.state.de.us/Legislature.nsf/?Opendatabase.

[31] State of New York, EPTL-SCPA Legislative Advisory Committee, "Proposed Changes to the Definition of Trust Accounting Income, to Redefine Appropriate Benefit Currently Distributable," *Supplement to Fifth Report*, May 26, 2000 (on file with author).

(a) The Pennsylvania Model. The Pennsylvania statute served as a base model for a number of other state statutes, particularly Alaska, Georgia, Iowa, Maine, New Hampshire, Oregon, and Washington. The Pennsylvania statute,[32] drafted before the release of the Proposed Regulations, provided for both the power to adjust and a unitrust conversion statute, but the options were mutually exclusive. It adopted a 4% unitrust rate,[33] a three-year "smoothing" provision,[34] an "ordering" provision for the payout of the unitrust amount from ordinary income first, then short-term capital gains, then long-term capital gains, and then from the principal of the trust.[35] The method of conversion was by a relatively simple process of written notice by the trustee to the current and remainder beneficiaries without court approval unless someone disagreed within the 60-day notice period.[36] Court approval was required however, to select a unitrust rate different from 4%, to require traditional accounting income to be distributed if greater than the unitrust amount, to select a smoothing period different from 3 years, to force a trustee to convert a trust into a unitrust, or to reconvert a unitrust to an income trust.[37] The adoption of a default unitrust rate of 4% was partly to strengthen the case that the distribution could be considered "income" for tax purposes, since it was uniform, and also to make the choices of the trustee less difficult, since this was an entirely new set of decisions for the trustee. And the choice of rate has no aspects of a "win-win" choice. Higher is better for the current beneficiary, and lower is better for the remainderman.

One of the aspects of the Pennsylvania statute that was copied by many states was the discretionary power it gave to the trustee to make the less major administrative decisions, such as the payout dates, how to handle short years, how frequently to value illiquid property, what valuation dates to use, how to treat property that is used by the beneficiary, and how to handle other distributions from or contributions to the trust.[38] The Pennsylvania statute also made it clear that trust provisions that gave the trustee power to distribute principal would not be affected by the conversion to a unitrust,[39] and expenses that would ordinarily be subtracted from income would not be subtracted from the unitrust amount.[40] In the ordinary income trust, the portion of the trustee's fee and other income expenses often make the income distribution quite unpredictable on a month to month or quarter to quarter basis, which is undesirable for the income beneficiary.

(b) The Delaware Model. The Delaware statute, despite being the first one actually enacted into law, had a number of features that were desirable and which were emulated by other states. The most important distinguishing feature was the trustee's ability to choose a unitrust rate in the range from 3% to 5%. This was largely a function of the speed with which the Delaware committee and legislature were able to react to the Proposed Regulations, which specifically indicated that range as acceptable.

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

(1) the intentions of the trustor, as reflected in the governing instrument,

(2) general economic conditions,

(3) projected current earnings and appreciation for the trust, and

(4) projected inflation and its impact on the trust.[41]

The trustee has discretion to determine the effective date of the conversion, the timing of distributions, and the valuation dates or the averages of valuations dates as are deemed appropriate.[42]

The Delaware law specifically grants the trustee the power to allocate short- and long-term capital gains to income for purposes of determining DNI.[43] As discussed later in connection with the Proposed and Final Regulations, this is important because it may both lower the total tax burden and make a higher payout rate prudent. Delaware's unitrust statute gives the trustee significant flexibility in administering their new total return unitrusts, particularly the flexibility of choosing a unitrust rate between 3% and 5%. This is favorable, provided that the trustees do not mind making some important choices in the process.

The Delaware law also had specific provisions for allowing a disinterested third party to be selected and make the decision as to the conversion and the rate of a unitrust.[44] The most important distinguishing feature of the Delaware law was to give the trustee the choice of rate within the permitted range, and this feature, with a twist added by the Illinois

[32] 20 Pa.C.S. §8101 et seq.
[33] 20 Pa.C.S. §8105 (d)(3).
[34] *Id.*
[35] 20 Pa.C.S. §8105 (f)(2).
[36] 20 Pa.C.S. §8105 (a).
[37] 20 Pa.C.S. §8105 (g).
[38] 20 Pa.C.S. §8105 (e).
[39] 20 Pa.C.S. §8105 (h).
[40] 20 Pa.C.S. §8105 (f)(1).
[41] 12 Del. Code §3527 (f).
[42] 12 Del. Code §3527 (i).
[43] 12 Del. Code §3527 (h)(2).
[44] 12 Del. Code §3527 (c).

statute, as discussed below, has been followed frequently in states adopting their statutes more recently, along with the ability of the trustee to employ the same process to reconvert the trust to an income trust. Giving the trustee both flexibility and informality of process is very important. Trustees and beneficiaries do not like to go to court, so the ability to act without court activity was quite important.

(c) The Illinois Model. Illinois adopted its unitrust statute on August 22, 2002, and drew upon both the Pennsylvania and the Delaware statutes in the process. Like Pennsylvania, a conversion by notification of the trustee was specified to be a 4% unitrust payout.[45] But like Delaware, a rate of not less than 3% nor more than 5% was possible, where the conversion was by agreement of the trustee and all of the beneficiaries of the trust entitled to notice under the statute.[46] This ability of the trustee and all of the beneficiaries to choose a rate by consensus was an important development that has been followed by a number of other states, including California, Indiana, Colorado, Nebraska and Wisconsin. It shifts the power and obligation to make the decision as to rate either to the court or to a consensus, which by nature must include the current beneficiary and one or more future beneficiaries.

Notice, while similar to the procedure in Pennsylvania and elsewhere, is given to the current eligible income beneficiaries and to the beneficiaries who would be next in line to receive benefits if the interests of all of the current beneficiaries were terminated.[47] This is quite different from all of the other state statutes, since the beneficiaries who are the "next takers" are often not the "remaindermen." For example, what if the trust provides income for life to spouse, and then on spouse's death in trust for the children, and then on the children's deaths, to the grandchildren? The Illinois statute would require notice to the decedent's spouse and also to the decedent's children, but not to the decedent's grandchildren. So one can argue that the Illinois statute ignores the remaindermen's interests where the next beneficiaries are not the remaindermen. On the other hand, the provisions of the Pennsylvania statute seem to ignore the interests of the beneficiaries in the middle; in the hypothetical case, the decedent's children.

The Illinois statute contains an ordering rule which starts with regular net income (accounting income of the trust), then ordinary income not included within regular net income,[48] before distributing short- and long-term capital gains. Unique to the Illinois statute is the ability of the trustee to release the power to convert to a unitrust just because the trustee feels that it is in the best interests of the trust to do so. In virtually all of the other state laws involving either the power to adjust or the power to convert to a unitrust, the power to release either remedy was based upon tax concerns or difficulties, whereas this statute allows the release just because the trustee thinks that the release is a good idea.[49]

Another area where the Illinois statute was different was in the area of trustee protection. The trustee is protected from claims made against him for any actions taken, or not taken, provided the trustee acts in good faith. In addition, the exclusive remedy is the conversion or reconversion to or from a unitrust, whichever is appropriate.[50] The action or inaction of a trustee under the act is presumed further to be reasonable and in good faith, and is barred by the statute of limitations of 2 years from the date that the trustee gave written notice of an action such that the objector knew or should have known of the action of which they complain. The Illinois statute did not follow the lead of the Delaware statute in dealing with a situation where all of the trustees are interested by appointing a new disinterested party, but instead relied upon the court procedure to "cleanse" any decision made by an interested trustee.[51]

(d) Other Directions—The Ohio TRU Safe Harbor and the Texas Unitrust Definition of Income. Ohio provides an interesting twist which combines the features of the power to adjust and the unitrust in its unique safe harbor provision.[52] Ohio did not adopt either the power to adjust or the power to convert to a unitrust or both in their purest forms, but chose instead a hybrid with the power to adjust as provided in the UPAIA with the strongest possible safe harbor provisions for upward adjustments of income not to exceed a 4% unitrust distribution. The power to adjust is contained in O.R.C. §1340.42, with the typical operative language, factors, qualifications, and exclusions, but the most critical lan-

[45] *See* 760 ILCS 5/5.3(a).

[46] *See* 760 ILCS 5/5.3(b).

[47] *Id.* at 5/5.3(a)(3).

[48] *See* 760 ILCS 5/5.3(f)(2).

[49] Do we want to give the trustee the power to avoid these choices that are so central to investing and distributing the trust? It would clearly increase the comfort level of trustees not wanting to exercise the powers in certain trust situations, but is it a good idea to give them the power to release themselves from considering their options on a continuing basis? This is an easier question to phrase than it is to answer, in the author's opinion.

[50] *See* 760 ILCS at 5/5.3(k).

[51] *Id.* at 5/5.3(c).

[52] H.B.No. 522, enacting O.R.C. §§1340.40-1340.42, 1340.46, 1340.47, 1340.51-1340.53, 1340.57-1340.59, 1340.63-1340.66, 1340.70-1340.77, 1340.80-1340.86, 1340.90, 1340.91 and repealing various sections.

guage is contained in §1340.42(G), which provides perhaps the strongest protective language for the benefit of the trustee of any of the total return statutes;

> (G) The liability of a trustee relative to the exercise of adjustment authority conferred by divisions (A) to (F) of this section shall be limited in the following manner:
>
> (1) Unless a court determines that a trustee has acted in bad faith, no trustee shall be held liable for damages for choosing not to make an adjustment.
>
> (2) Unless a court determines that a trustee has acted in bad faith with respect to an adjustment, the sole remedy to be ordered by a court shall be a prospective correction of the adjustment.
>
> (3) <u>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.</u> (Emphasis inserted.)

In a number of ways, the Ohio statute grants trustees far greater protection than Section 105 of the UPAIA.[53] First, Section 105 of the Uniform Act uses a general abuse of discretion standard. This is likely the standard under the Ohio statute as well for the court to grant *some remedy*, but for the trustee to be liable in damages for choosing not to make an adjustment, the court must affirmatively find bad faith, an extremely tough standard; and again, if an adjustment is made, the sole remedy for an adjustment that is allegedly improper is a prospective correction of the adjustment unless a bad faith finding has been made.[54] Section 105, on the other hand, expressly allows damages from the

---

[53] **SECTION 105. JUDICIAL CONTROL OF DISCRETIONARY POWERS.**

(a) A court may not order a fiduciary to change a decision to exercise or not to exercise a discretionary power conferred by this [Act] unless it determines that the decision was an abuse of the fiduciary's discretion. A fiduciary's decision is not an abuse of discretion merely because the court would have exercised the power in a different manner or would not have exercised the power.

(b) The decisions to which subsection (a) applies include:

(1) A decision under Section 104(a) as to whether and to what extent an amount should be transferred from principal to income or from income to principal.

(2) A decision regarding the factors that are relevant to the trust and its beneficiaries, the extent to which the factors are relevant, and the weight, if any, to be given to those factors, in deciding whether and to what extent to exercise the discretionary power conferred by Section 104(a).

(c) If the court determines that a fiduciary has abused the fiduciary's discretion, the court may place the income and remainder beneficiaries in the positions they would have occupied if the discretion had not been abused, according to the following rules:

(1) To the extent that the abuse of discretion has resulted in no distribution to a beneficiary or a distribution that is too small, the court shall order the fiduciary to distribute from the trust to the beneficiary an amount that the court determines will restore the beneficiary, in whole or in part, to the beneficiary's appropriate position.

(2) To the extent that the abuse of discretion has resulted in a distribution to a beneficiary which is too large, the court shall place the beneficiaries, the trust, or both, in whole or in part, in their appropriate positions by ordering the fiduciary to withhold an amount from one or more future distributions to the beneficiary who received the distribution that was too large or ordering that beneficiary to return some or all of the distribution to the trust.

(3) To the extent that the court is unable, after applying paragraphs (1) and (2), to place the beneficiaries, the trust, or both, in the positions they would have occupied if the discretion had not been abused, the court may order the fiduciary to pay an appropriate amount from its own funds to one or more of the beneficiaries or the trust or both.

(d) Upon [petition] by the fiduciary, the court having jurisdiction over the trust or estate shall determine whether a proposed exercise or nonexercise by the fiduciary of a discretionary power conferred by this [Act] will result in an abuse of the fiduciary's discretion. If the petition describes the proposed exercise or nonexercise of the power and contains sufficient information to inform the beneficiaries of the reasons for the proposal, the facts upon which the fiduciary relies, and an explanation of how the income and remainder beneficiaries will be affected by the proposed exercise or nonexercise of the power, a beneficiary who challenges the proposed exercise or nonexercise has the burden of establishing that it will result in an abuse of discretion." Unif. Principal and Income ACT §105, 7B U.L.A. (2000).

[54] O.R.C. §1340.42(G)(1)-(2).

trustee's own funds if the parties cannot otherwise be placed in the position they would have been but for the abuse of discretion.[55] In addition to the foregoing. a trustee can, from time to time, make a "safe-harbor" adjustment to increase the "net trust accounting income" up to and including an amount equal to 4% of the fair market value of the trust as of the first business day of the current year, and if such an adjustment is made, the "propriety" of the adjustment shall be conclusively presumed. Taken as a whole, the power to adjust can be used safely by the trustee subject only to a bad faith standard, and if it is within the safe harbor territory up to 4%, the adjustment would be safe from any ordinary attack.

The relative safety and security granted to the Ohio trustee is clearly a positive, as it should encourage the trustee to use the power to adjust. One of the greatest risks for all of the total return trust legislation is that the trustees may feel sufficiently vulnerable that they take no action either under the power to adjust, or, where available, the power to convert to a unitrust. This is precisely the opposite effect from what is intended by such legislation, universally intended to provide greater flexibility of approach for the trustee attempting to invest prudently and distribute fairly. But there are downsides to this approach as well:

1. A safe harbor range will tend to discourage adjustments outside of the safe harbor range. It seems likely that most adjustments will in fact be to a 4% unitrust distribution, because that is the safe harbor. While that may be a good result in some of the cases; in others, a different more flexible adjustment policy may be preferable. For example, a long-term trust that is exempt from GST tax may find a 3% distribution pattern preferable, by allowing the investment for total return, and encouraging long-term growth in value in the trust. And, by the same token, an adjustment somewhat in excess of 4% may be optimal for a shorter term trust for an older beneficiary where enjoyment of a healthy current return may be more important and more consonant with the settlor's intent than long-term growth encouraged by a lower payout rate.

2. While an adjustment to 4% should be very secure for the trustee, the beneficiary is not assured of a consistent payout from year to year, precisely because the trustee is largely safe from attack on the exercise of discretion. <u>The unitrust provides an assurance of payout policy that is not equaled by any trustee power.</u> In theory, the trustee can change his mind from year to year, depending upon market conditions, and while this is an advantage in some circumstances, that very flexibility entails uncertainty, which is not a positive for the beneficiary.

3. It is unclear whether under the Ohio statute, a marital trust drafted as a 4% unitrust would qualify for the marital deduction under the Final Regulations.

4. The Ohio statute only provides a safe harbor for an *upward adjustment*, not a downward adjustment, and while this is the more pressing need at present, there may come a time when this is unduly limiting. For example, if a trustee had the prescience to sell her equity holdings in February of 2000 and invest entirely in bonds, one would hope that the power to adjust would allow the trustee to allocate at least a little bit of the yield to principal, presumably at least down to 4%, since otherwise the asset allocation would seem prejudicial to the remainder beneficiaries (although in hindsight, it would have been helpful to both the current and remainder beneficiaries). And it is well to remember that interest rates always take into account inflationary expectations that are effectively built into the interest rates themselves. In the period from 1977 to 1980, inflation as measured by the

[55] Unif. Principal and Income Act §105(c)(3), 7B U.L.A. (2000).

> consumer price index actually exceeded the very high interest rates in those years,[56] and in such an environment, it is particularly critical that the trustee be able to adjust down, as well as up.

For states desiring hybrid legislation of the safe harbor unitrust standard, Ohio's statute may be a better starting point than the New Jersey legislation, which provides much less protection for the trustee, with only a presumption that an adjustment within the safe harbor limits is fair and reasonable to the parties involved.[57]

Texas adopted its own version of the Prudent Investor Act and the Uniform Principal and Income Act with an interesting twist, in that while it did not contain a unitrust conversion feature for existing trusts, it did contain a clear definition of a unitrust amount between 3% and 5% of the net fair market value of the trust's assets as an alternative definition of income which may be adopted by a drafter:

> (b) In this section:
>
> (1) "Unitrust" means a trust the terms of which require distribution of a unitrust amount.
>
> (2) "Unitrust amount" means a distribution mandated by the terms of a trust in an amount equal to a fixed percentage of not less than three or more than five percent per year of the net fair market value of the trust's assets, valued at least annually. The unitrust amount may be determined by reference to the net fair market value of the trust's assets in one year or more than one year.
>
> (c) Distribution of the unitrust amount is considered a distribution of all of the income of the unitrust and shall not be considered a fundamental departure from applicable state law. A distribution of the unitrust amount reasonably apportions the total return of a unitrust.
>
> (d) Unless the terms of the trust specifically provide otherwise, a distribution of the unitrust amount shall be treated as first being made from the following sources in order of priority:
>
> (1) from net accounting income determined as if the trust were not a unitrust;
>
> (2) from ordinary accounting income not allocable to net accounting income;
>
> (3) from net realized short-term capital gains;
>
> (4) from net realized long-term capital gains; and
>
> (5) from the principal of the trust estate.[58]

By providing a statutory unitrust definition of income, Texas' statute should allow a drafter to use a unitrust in drafting a marital QTIP trust, which, particularly in the context of second marriages, may be uniquely helpful to all concerned.

(e) A "Stealth" Unitrust Conversion Statute Argument? As discussed previously in the detailed section examining the Uniform Act and the Power to Adjust, the Comments added to Section 105 are clearly intended to broaden and empower trustees seeking to use the power to adjust and limit the actions which might be deemed unreasonable so as to give the power to adjust its greatest latitude and flexibility. Those comments make it quite clear that the power to adjust may be utilized in the manner of a unitrust:

> [the trustee] may consider the amount that would be distributed each year based on a percentage of the portfolio's value at the beginning or end of an accounting period, or the average portfolio value for several accounting periods, in a manner similar to a unitrust, and may select a percentage that the trustee believes is appropriate for this purpose and use the same percentage or different percentages in subsequent years.[59]

Does this give sufficient support for a unitrust definition of income to allow a drafter in a state with only the Uniform Act to draft a unitrust without an "income if greater" provision and claim qualification

[56] Intermediate Government Bond Yields 1977-1980 were 6.49%, 7.83%, 9.04% and 10.55%, respectively, while inflation totaled 6.77%, 9.03%, 13.31%, and 12.40%, respectively. *See* Ibbotson Associates, *supra* n. 4, at Table 2-6, pp. 40-41 and Table A-15, pp. 252-253.

[57] N.J.S.C.3B:19B-4.

[58] Tex. Prop. Code Ann. §116.006. The word "accounting" in (d)(2) should likely be deleted.

[59] Unif. Principal and Income Act, *supra* n. 11, §105, comment.

for the marital deduction? Is there support within the Uniform Act for the proposition that a court approved conversion to a unitrust in a Uniform Act state is "pursuant" to an applicable state statute, and thus protected by the Final Regulations from concerns of loss of the marital deduction, GST grandfathering or sale or exchange treatment under *Cottage Savings?*[60] Letter Ruling 200448001 issued July 21, 2004 represents a very liberal ruling lending support to that point of view. In that ruling, the beneficiary co-trustee of an income only trust petitioned the Court to modify the trust so as to provide for a payout of the net income or a unitrust amount, whichever is greater:

> Daughter 1, as co-trustee of Trust, petitioned County Court requesting the modification of Paragraph 7 of Trust governing the administration of Trust A. Under Paragraph 7 as modified, the trustee will pay Daughter 1, annually a "Unitrust Amount" equal to f% of the average of the fair market value of the total Trust A assets as of the close of the most recent calendar year and the close of the previous two calendar years. If, in any year, the net income generated by the Trust A assets exceeds the Unitrust Amount, the excess amount is to be paid to Daughter 1. The Unitrust Amount is to be paid first from income, then from short-term capital gains, then from long-term capital gains, then, to the extent necessary, from principal.

Three rulings were requested on these facts:

1. That there was no loss of grandfathering for GST purposes;
2. That capital gains would be allocated to Distributable Net Income under Section 643; and
3. That the conversion of an "income-only" trust to a "total return" trust will not result in a sale or exchange under section 1001 with respect to Daughter 1.

Favorable rulings were obtained on all three questions. The first issue was clear enough, inasmuch as the payment of income or unitrust amount, whichever was greater, could "only operate to increase the amount distributable to A and decrease the amount distributable to A's issue" just as illustrated in the final GST Regulations governing modification of grandfathered trusts.[61]

The second issue was also resolved favorably:

> Section 1.643(a)-3(a) of the Income Tax Regulations provides generally that gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income and are not considered paid, credited, or required to be distributed to any beneficiary unless they are (i) allocated to income under the terms of the governing instrument or local law by the fiduciary on its books or by notice to the beneficiary, (ii) allocated to corpus and actually distributed to the beneficiaries during the taxable year, or (iii) utilized (pursuant to the terms of the governing instrument or the practice followed by the fiduciary) in determining the amount that is distributed or required to be distributed. Accordingly, we conclude that, capital gains that are distributed to the income beneficiary will constitute distributable net income under section 643.[62]

The governing instrument and local law did not so provide, authority being drawn only as a result of the decision of the local court (not the highest court in the state under Bosch),[63] and yet the letter writer approved this treatment. It is difficult to reconcile the highly technical wording of the Final Regulations discussed later with this liberal ruling. And the inclusion of the capital gains into DNI was as a result of an ordering rule (by a local court), and not a power. Hopefully this reflects a more liberal view of inclusion of capital gains in DNI, which sensibly should not require either a state statute or a high court ruling. When it gets down to it, after all, 15% is 15%!

And the ruling on the *Cottage Savings* issue was just as liberal, though the rationale was more clearly stated:

> The administration of a trust in conformance with applicable state law that permits the trustee to adjust between principal and income to fulfill the

[60] *Cottage Savings Association v. Commissioner,* 499 U.S. 554, 111 S. Ct 1503 (1991).

[61] Treas. Reg. §26.2601-1(b)(4)(E), Ex. 8.

[62] PLR 200448001 (July 21, 2004).

[63] *Comm'r v. Estate of Bosch,* 387 U.S. 456, 87 S Ct 1776 (1967).

> trustee's duty of impartiality between income and principal beneficiaries will not be treated as a taxable exchange for federal income tax purposes by either the trust or the beneficiaries. Because State Law provides the trustee the power to administer Trust A in the same manner as proposed in the modification, the modification is not treated as an exchange of trust interests by the beneficiaries or the trust.

This is a very generous ruling also. There is no doubt that a trustee in a state that has adopted the power to adjust has the ability to implement the power to adjust in a manner similar to a *de facto* unitrust, but if the court converts the income trust into a unitrust, they have actually created something quite different than the *power* given by the power to adjust, because the trustee is then *required* to distribute the trust as a unitrust. Only in Kentucky does the law regarding the power to adjust require court approval before any exercise of the power to adjust.[64] While the power to adjust can be employed in a unitrust manner, it may also be employed in other manners, such as using other types of distribution rules as explained in the comment to Section 105, discussed previously. There is no doubt that from the beneficiary's point of view a unitrust wherein the trustee is *required* to pay out 4% annually is very different from a trust where the trustee has the *discretion* to pay out 4% annually. This is a very liberal ruling, but helpful to trustees and beneficiaries in states without a unitrust conversion statute. There seems no reason not to try such an approach on a court and the IRS again. It worked well once at least! But it would, of course, be unwise to rely upon this Letter Ruling for any other client or trust in the absence of clear authority, which is not present at the moment.

If a trustee wished to follow the tracks in the snow left by 200448001 in a state with no unitrust conversion statute, the strongest way to frame the issue would be for the trustee to petition the court for an advance determination under Section 105(d) of the reasonableness of a prospective adjustment. And that prospective adjustment to the income of the trust would be to adjust principal to income, or income to principal, as necessary to form an income interest that is equal to a unitrust interest calculated as 4% of the value of the trust fund averaged over a three year period, such prospective adjustment to be made for as long as the trust shall continue, or until the trustee were to again petition the court for a determination of the reasonableness of a change to that method of adjustment. Now that is certainly getting closer to our goal of having a state unitrust statute, as it would be a court approval of a method of exercising the power to adjust under a state statute that would be a unitrust method.

Much as the writer might like to find that authorization within the Uniform Act that would pass muster with the IRS, skepticism wins the day, based upon a few distinctions. First, even if such a court proceeding were brought and approved, the trustee would still have the power to adjust differently from the unitrust method, since the advance determination under Section 105(d) would simply rule that such a method would be a reasonable exercise of the power to adjust. The court is not authorized under any statute of which the writer is aware to mandate that method of adjustment. So if the trustee is still free to exercise the power to adjust in a manner different from a unitrust, then it would seem that the court hasn't actually approved a conversion to a unitrust, and if it has, then it is not pursuant to the more or less plain words of the Uniform Act, even with the addition of the more expansive comments added to Section 105.

And if the Uniform Act were considered to be sufficient, would it pass muster with the Service without any boundaries to the percentage payouts on the unitrusts to be created? It is clear enough that 3% to 5% is as far as Treasury was going on this score, but if the payout rate suggested were within the 3% to 5% range, it would not necessarily be different in this regard from a number of the statutes where a court might choose a different rate from the default rate chosen in the statute. Perhaps this is not critical, since the power to adjust itself has no high and low limits beyond the imposition of an abuse of discretion standard under Sections 105 and the criteria in 104 itself.

Whether this approach may find some success in states without a unitrust statute is difficult to say at this point. It seems, however, that if a court proceeding were brought under these auspices, and the court were to *really convert an income trust to a unitrust,* so that the trustee would be *required* to distribute a unitrust amount henceforth, a private letter ruling request should be submitted as well to protect those involved from possible loss of GST exemption (unless like 200448001, it also ordered the payout of "income if greater" to the highest generation), or from a possible sale or exchange treatment.

The following is a current chart of the total return legislation in the United States as of the time of this writing. *(See pages 22-25.)* For the most part, the legislative references for the power to adjust are not included, inasmuch as the wording in most of the states tracks the Uniform Act discussed previously,

[64] *See* KRS 386.454.

but for reference to any specific trust situation, obviously the statute itself should be reviewed with care for deviations from the Uniform Act, as such changes, though not common, may be important. Pennsylvania, for example, does not track the language in the Uniform Act with respect to prohibiting adjustments from property set aside for charitable purposes, because it would prohibit adjustments for trusts with a partially charitable remainder, which really don't receive any income or death tax benefits which might be threatened by the power to adjust.[65] In the "Notes" column a reference is included to the unitrust statute rate and who has power to select a choice of rate if there is a choice, whether there is tax ordering for capital gains tax purposes, and whether there is specific statutory trustee protection, as well as other important distinguishing characteristics of a state statute in a few cases.

[65] 20 Pa.C.S. §8104 (c)(3).

Jurisdictions with Uniform Principal and Income Act Section 104 and/or Unitrust Conversion Option					
Jurisdiction	**Sec 104**	**Unitrust**	**Notes**	**UNITRUST CITATION**	**Unitrust Conversion URL Citation**
Alabama	Yes	No			
Alaska	Yes	Yes	Effective 9/01/03 Adapted from PA Statute w/Modifications, Tax Ordering	Alaska Stat. Section 13.38.200 et seq.	http://www.legis.state.ak.us/basis/get_bill_text.asp?hsid=SB0087Z&session=23
Arizona	Yes	No			
Arkansas	Yes	No			
California	Yes	Yes	Effective 1/1/2006 4% unitrust, or with agreement or Court Order, 3-5% Unitrust, Tax Ordering Tax Updated for Express Unitrusts	Cal. Probate Code Section 16336.4 et seq.	http://www.leginfo.ca.gov/cgi-bin/postquery?bill_number=sb_754&sess=CUR&house=B&author=poochigian
Colorado	Yes	Yes	Eff. 5/22/2003 4% unitrust, or 3-5% w/agreement or Court Order Tax Ordering Strong Trustee Protections	Col. Rev. Stat.15-1-402	http://198.187.128.12/colorado/lpext.dll?f=templates&fn=fs-main.htm&2.0
Connecticut	Yes	No			
Delaware	Yes	Yes	Eff. 6/21/2001 3-5% Rate at Trustee's Option-Tax Ordering Tax Updated for Express Unitrusts	Title 12 Delaware Code Section 3527 & 3527A and 6113	http://www.delcode.state.de.us/title12/c035/sc02/index.htm#TopOfPage
District of Columbia	Yes	No			
Florida	Yes	Yes	Eff. 1/01/03–Only available when no Power to Adjust 3-5% Rate Option or 1/2 7520 rate b/t 3% & 5%, Tax Ordering Power, Updated for Express Unitrusts	Section 738.101 et. seq.; Sec. 738.1041	http://www.leg.state.fl.us/Statutes/index.cfm?App_mode=Display_Statute&Search_String=&URL=Ch0738/SEC1041.HTM&Title=->2005->Ch0738->Section%201041#0738.1041
Georgia	Yes	Yes	Eff. 7/1/2005, 4% Modeled After PA Law, Tax Ordering, Trustee Protection	GA. Code Ann. 53-12-220 and 221	http://www.legis.state.ga.us/legis/2005_06/search/hb406.htm
Hawaii	Yes	No			
Idaho	Yes	No			

Jurisdiction	Sec 104	Unitrust	Notes	UNITRUST CITATION	Unitrust Conversion URL Citation
Illinois	No	Yes	Eff. 8/22/2002 4% Default, 3-5% w/consent of Benies & Trustees. Tax Ordering, Trustee Protection, Updated for Express Unitrusts	760 Illinois C.S. 5/5.3 et. seq.	http://www.ilga.gov/legislation/ilcs/ilcs3.asp?ActID=2117&ChapAct=760%26nbsp%3BILCS%26nbsp%3B5%2F&ChapterID=61&ChapterName=TRUSTS+AND+FIDUCIARIES&ActName=Trusts+and+Trustees+Act%2E&Print=True
Indiana	Yes	Yes	Effective 7/1/03-5% Default 3-5% With Agreement, Tax Ordering, Trustee Protection	IC 30-2-14-15	http://www.in.gov/legislative/ic/code/title30/ar2/ch15.pdf
Iowa	No	Yes	Eff. 4/5/2002-4%, 3-5% By Court Order, Tax Ordering	15 Iowa Code Section 637-601 et seq.	http://nxtsearch.legis.state.ia.us/NXT/gateway.dll/moved%20code/2005%20Iowa%20Code/1/23055/24253/25022?f=templates$fn=defaultURLQueryLink.htm$q=[field%20folio-destination-name:'ch_637']$x=Advanced
Kansas	Yes	No			
Kentucky	Yes	Yes	Effective 1/1/05. No separate unitrust statute. Unitrust method of exercising power to adjust if 3-5%. Power to adjust allowed only with Court Approval	KRS 386.454	http://www.lrc.state.ky.us/KRS/386-00/454.PDF
Louisiana	Yes	No	Just Section 104- not the rest of UPAIA		
Maine	Yes	Yes	Eff. 3/22/02 4% Default-very similar to PA Statute Tax Ordering	Chap. 544 Sec. 1 18-A MRSA Sec. 7-705	http://janus.state.me.us/legis/statutes/18-a/title18-Asec7-705.html
Maryland	Yes	Yes	Eff. 10/1/02, 4% Unitrust Tax Ordering Power, Some Trustee Protection	Chapter 478 Section 15-502.1 et seq.	http://198.187.128.12/,maryland/lpext.dll?f=templates&fn=fs-main.htm
Massachusetts	Yes	No	HB740/SB962		2pub501%2D5501/pub501%2D550%2D43.htm

Jurisdiction	**Sec 104**	**Unitrust**	**Notes**	**UNITRUST CITATION**	**Unitrust Conversion URL Citation**
Michigan	Yes	No		Act No. 159, Public Acts of 2004, eff. 9/1/04	
Minnesota	Yes	No		Minnesota Statutes Section 501B.705	http://www.revisor.leg.state.mn.us/stats/501B/705.html
Mississippi	No	No			
Missouri	Yes	Yes	Eff. 8/28/2001 Revised 11/8/2004 3-5% No Tax Ordering, Tax Updated	Chapter 469.411 et seq.	http://www.moga.state.mo.us/statutes/c400-499/4690000411.htm
Montana	Yes	No			
Nebraska	Yes	Yes	Eff. Sept. 4, 2005, 4% Default, 3-5% w/consent of Trustees and Ben, Tax Ordering, Trustee Protection	Nebraska Revised Statutes 30-3119.01	http://srvwww.unicam.state.ne.us/Statutes2005.html
Nevada	Yes	No			http://www.leg.state.nv.us/72nd/Bills/SB/SB196.html
New Hampshire	No	Yes	Eff 1/1/2003 5% Rate-Patterned after PA Statute Tax Ordering	Chapter 544A RSA Section 564-A:3-c	http://www.gencourt.state.nh.us/rsa/html/LVI/564-A/564-A-3-c.htm
New Jersey	Yes	Unitrust Safe Harbors	Adjustment up to 4% or down to 6% presumed reasonable		http://www.njlawnet.com/njstatutes.html
New Mexico	Yes	No			
New York	Yes	Yes	4% Default Rate, Conversion for old trusts expires 12/31/2005	Article 11 Section 11-2.1 et seq.	http://public.leginfo.state.ny.us/menugetf.cgi?COMMONQUERY=LAWS
North Carolina	Yes	Yes	Eff. 1/1/2004 Delaware Style Unitrust Statute (3-5%),Tax Ordering Power, Trustee Protection	N.C. Gen. Stat. Sec. 37A-1-101 et seq.	http://www.ncga.state.nc.us/gascripts/Statutes/StatutesSearch.asp?searchScope=All&searchCriteria=unitrust&returnType=Section
North Dakota	No	No	Adopted the Uniform Act without Section 104		
Ohio	Yes	4% Unitrust Safe Harbor	Eff. 1/1/ 2003-Adjustment Up to 4% Conclusively Presumed To Be Proper	RC 1340.42	http://onlinedocs.andersonpublishing.com/oh/lpExt.dll?f=templates&fn=main-h.htm&cp=PORC
Oklahoma	Yes	No			

Jurisdiction	Sec 104	Unitrust	Notes	UNITRUST CITATION	Unitrust Conversion URL Citation
Oregon	Yes	Yes	Eff. 1/1/2004, 4% Unitrust patterned after PA Statute, Tax Ordering Rule	ORS 129.225	http://www.leg.state.or.us/cgi-bin/searchMeas.pl
Pennsylvania	Yes	Yes	Eff. 7/15/02, 4% Default Rate-Tax Ordering, Tax Updating Proposed	20 Pa. C.S.A. Section 8105	http://www.legis.state.pa.us/2001%5F0/sb1014p1431.htm
Rhode Island	No	No			
South Carolina	Yes	No			
South Dakota	No	Yes	Eff. 7/1/2002 3% Rate-Tax Ordering-Trustee Protection	15 SD Codified Laws Sec. 55-15-1 et seq.	http://legis.state.sd.us/statutes/Index.cfm?FuseAction=Display Statute&FindType=Statute&txtStatute=55-15
Tennessee	Yes	No			
Texas	Yes	No (but TRU Inc. def.)	Tax Updated Definition of Income for Express Unitrust, Tax Ordering	Tex. Prop. Code Ann. Sec. 116.001 et seq.	http://www.capitol.state.tx.us/statutes/docs/PR/content/htm/pr.009.00.000116.00.htm#116.007.00
Utah	No	No			
Vermont	No	No			
Virginia	Yes	Yes	Eff. 7/1/2004 3-5% Unitrust Rate, Tax Ordering Power Trustee Protection, Does not Prohibit Power to Adjust	Va. Code Sec. 55-277.4:1	http://leg1.state.va.us/cgi-bin/legp504.exe?000+cod+55-277.4C1
Washington	Yes	Yes	4% Default-Patterned after PA Bill, Tax Ordering Provisions	RCW11.104A.040	http://www.leg.wa.gov/RCW/index.cfm?fuseaction=chapterdigest&chapter=11.104
West Virginia	Yes	No			
Wisconsin	Yes	Yes	Eff. 5/17/2005 3-5% Unitrust chosen by Trustee or Court, unanimous consent of Ben required unless by Court	Wisc. R. Statutes 701.20(4),(4)(g)	http://www.legis.state.wi.us/rsb/Statutes.html
Wyoming	Yes	No			
Total In Force w/Section 104	41 + D.C.				
Total Unitrust	23	+OH& NJ Have Unitrust Safe Harbors	Total Both 19		
Total Pending	0				
Total Pending States	In Bill Form	Pending 104 Only	Pending Unitrust Only	Pending Both	Pending 104 Safe Harbor
	0	0	0	0	0

4. Non-Tax Technical Issues and Fixes. These total return statutes, and particularly the unitrust statutes that have been enacted in the last four years, represent a revolution in the way we approach the investment and distribution of trusts. While the approaches that have been used in different states are in part due to differences in trust policy as to what the legislatures and the legislative advisory committees thought was best for their trusts, trustees and beneficiaries, they (we) were breaking new ground, and in hindsight, we didn't get it all right in the first go around. The following offers a few thoughts for consideration of non-tax fix-ups that might be desirable in the unitrust legislation that does not have to do with technical tax matters.

(a) Notice to Parties in Interest. A number of the state statutes followed the form of legislation in Pennsylvania and while the statute read well, we didn't get it quite right. Under the Pennsylvania statute, the notice would be given to the current income beneficiary and to the remaindermen if the trust were to terminate at the time of the giving of notice. What is missing is the person or persons in between. For example, a trust for mother, and then for daughter, and then for grandchildren, terminating when the grandchildren reach age 30, should require notice to all three classes of beneficiaries representing the three generations, but Pennsylvania's current statute does not clearly require notice to the daughter. The following, drawn from language in the Uniform Trust Act, is suggested:

> (2) The trustee gives written notice of the trustee's intention to release the power to adjust and to convert the trust into a unitrust and of how the unitrust will operate, including what initial decisions the trustee will make under this section, to all the *sui juris* beneficiaries who:
>
> (i) are currently eligible to receive income from the trust; [and]
>
> (ii) would be eligible to receive, if no powers of appointment were exercised, income from the trust if the interest of all those eligible to receive income under subparagraph (i) were to terminate immediately prior to the giving of notice; and
>
> (iii) would receive, if no powers of appointment were exercised, a distribution of principal if the trust were to terminate immediately prior to the giving of notice.

However, if all three classes are required to have representatives who are *sui juris*, there may be more need for court activity than is desirable, and hence the following phrasing is suggested:

> There is at least one *sui juris* beneficiary under paragraph (2)(i) and at least one *sui juris* beneficiary under either paragraph (2)(ii) or (2)(iii).[66]

The second class of beneficiaries, the "next" income beneficiaries, is thought to be sufficient to represent the remainder beneficiaries, and in any event it seems that such a more flexible requirement will eliminate what are likely to be unnecessary court proceedings. States which have used the same language as Pennsylvania would do well to make this correction, and in the absence of such correction, counsel would do well to notify the "mezzanine generation" as well as the current beneficiary and the remaindermen. They are clearly parties in interest.

(b) And Speaking of Court Proceedings. One of the areas that differentiates the state unitrust statutes is the degree to which court involvement is required or discouraged. Our Pennsylvania statute allows many conversions to occur without court involvement, but there are many things that require court involvement, such as a reconversion to an income trust, a rate different from 4%, a smoothing rule different from 3 years, or the payment of traditional "income" if greater than the unitrust amount if needed for tax reasons.[67] Anecdotally, the requirement of court involvement for a reconversion appears to have discouraged conversions to a unitrust, as trustees did not want to be "stuck" in a unitrust mode, unless they were willing to go to court, and trustees generally do not want to go to court.

While these requirements were intended to make the case for the unitrust as a proper definition of income stronger for tax purposes, at this point it seems clear that allowing reconversions to an

[66] This suggestion, made by Bob Freedman and Ted Watters of Philadelphia, is the best solution the author has seen as to who should receive notice and who must be *sui juris* for court activity to be avoided. The deficiency was pointed out by Lyman Welch of Chicago, whose Illinois version contained the first two classifications, but not the remaindermen, out of concern that guardians ad litem and court activity would be too frequently required if this class were inserted.

[67] 20 Pa.C.S. §8105 (g).

income trust ought to be allowed upon the same conditions and procedures as the conversion from an income trust to a unitrust. This is allowed in a number of states, and was the model used in the Delaware statute.[68]

In addition, the flexibility to choose a rate consensually, as was done in the Illinois model if the trustee and all of the beneficiaries consent,[69] seems to be quite sensible as long as it is within the 3-5% range, permitted by the Final Regulations.

Again, encouraging flexibility seems wise in choosing a three-year smoothing rule or other rules. Such flexibility is built into a few state statutes, such as Delaware.[70] For reasons that will become clear after our discussion of further research on the "best" smoothing rule, this flexibility may well be of value.

B. STOCK PRUNING, CAPITAL GAINS TAX AND JGTRRA—MAKING MORE INTO EVEN MORE

Another relatively new development that critically affects total return trusts is the changes brought by the Job Growth and Tax Revenue Reconciliation Act of 2003 ("JGTRRA").[71] In recent financial markets, the use of a TRU will encourage the use of a greater proportion of stocks and other equity investments, as opposed to fixed income, by virtue of the flexibility the TRU provides and the fact that equity securities over longer periods tend to produce a higher total return.

In addition, recent financial markets with a TRU invested primarily in equities would inevitably lead to the periodic use of a small amount of the principal every year to meet the distribution payouts required by the trust. Traditionally, this practice, which the author has called "stock pruning," would seem aggressive or even speculative, but the investment data presented in these materials and the author's prior works tends to show otherwise. In fact, the use of a little bit of the growing portfolio to make up a portion of the distribution is not just a necessity, it is actually a tax planning opportunity. And this tax planning opportunity, which was tremendous before JGTRRA, is just amazing after JGTRRA!

To demonstrate the tax advantages, two different portfolios of $100,000 each will be created, one invested in taxable fixed income and the other in a widely diversified group of individual stocks with a current level of dividends of 2% and appreciation of 6% per year.[72] **To level the playing field, the same total return of 8% will be assumed for both trusts as well as a constant trust payout of 4% per year. The rate of tax inside the trust for any reinvested ordinary income will be 31%.**[73] **A 31% tax bracket will be assumed for the trust beneficiary as well. Both the fund balance and the after-tax distribution to the trust beneficiary appreciate significantly in this all fixed income model but the tax does its damage. Every dollar of return is taxed every year.** *(See Table 1.)*

TABLE 1:

TOTAL RETURN TRUST-TAXABLE FIXED INCOME RETURN OF 8% PER YEAR AND A 4% PAYOUT TAX RATE OF BENEFICIARIES AND TRUST 31%

Year	Balance	Total Return	Pre-Tax Dist.	After Tax Dist.	Year End Balance
1	100,000	8,000	4,000	2,760	102,760
2	102,760	8,221	4,110	2,836	105,596
3	105,596	8,448	4,224	2,914	108,511
4	108,511	8,681	4,340	2,995	111,506
5	111,506	8,920	4,460	3,078	114,583
6	114,583	9,167	4,583	3,162	117,746
7	117,746	9,420	4,710	3,250	120,995
8	120,995	9,680	4,840	3,339	124,335
9	124,335	9,947	4,973	3,432	127,766
10	127,766	10,221	5,111	3,526	131,293
11	131,293	10,503	5,252	3,624	134,916
12	134,916	10,793	5,397	3,724	138,640
13	138,640	11,091	5,546	3,826	142,467
14	142,467	11,397	5,699	3,932	146,399
15	146,399	11,712	5,856	4,041	150,439
16	150,439	12,035	6,018	4,152	154,591
17	154,591	12,367	6,184	4,267	158,858
18	158,858	12,709	6,354	4,384	163,243
19	163,243	13,059	6,530	4,505	167,748
20	167,748	13,420	6,710	4,630	172,378

Total distributions after tax = 72,378
Trust balance after 20 years =172,378

[68] *See* text at nn. 41-44, *supra*.

[69] *See* text at n. 46. 48, *supra*.

[70] 12 Del. Code §3527 (i).

[71] Public Law 108-27.

[72] And all of these assumptions are reasonably in line with current economic conditions and prognostications. The current dividend rate on the Vanguard Index 500 Admiral Shares has a 30-day SEC yield of 1.7%, whereas the historical average of that same index has been a bit over 4%. There are many who believe that future returns will be several percent lower than historical returns, in no small part because of a loss in the dividend component of stock returns.

[73] This rate is a conservative assumption (one likely to cut against the proposition proposed by the author) considering that for estates and trusts, the 35% bracket begins at $10,050 for 2006. *See* http://www.irs.gov/formspubs/article/0,,id=112782,00.html.

The 4% payout in Table 1 after 31% tax gives an after-tax return of 2.76% and the 4% income earned in the trust yields the same 2.76% compounded. This result still seems appealing until it is compared to the use of the TRU with equities. For purposes of showing the effect of JGTRRA on the effective tax rate, we have provided both pre- and post-JGTRRA tax rates and results. *(See Table 2.)*

TABLE 2:
TOTAL RETURN TRUST - 100% EQUITY - DIVIDENDS OF 2% AND CAPITAL GROWTH OF 6% - 4% PAYOUT - THE TAX EFFICIENCY OF STOCKS AND STOCK PRUNING MULTIPLIES RETURNS

Year	Trust Fund Balance	Taxable Dividend	Growth	Distribution	Stock "Pruned" & Distributed	Cost Basis Used	Remaining Cost Basis	Pre-JGTRRA after tax Distribution	Post-JGTRRA after tax Distribution	Year End Fund Balance	Pre-JGTRRA Effective tax rate on Pruned Principal	JGTRRA Effective tax rate on Pruned Principal	JGTRRA Increase in after tax income
1	100,000	2,000	6,000	4,000	2,000	1,887	98,113	3,357	3,683	104,000	1.1%	0.8%	9.7%
2	104,000	2,080	6,240	4,160	2,080	1,851	96,262	3,469	3,814	108,160	2.2%	1.7%	9.9%
3	108,160	2,163	6,490	4,326	2,163	1,816	94,446	3,586	3,950	112,486	3.2%	2.4%	10.1%
4	112,486	2,250	6,749	4,499	2,250	1,782	92,664	3,708	4,092	116,986	4.2%	3.1%	10.3%
5	116,986	2,340	7,019	4,679	2,340	1,748	90,915	3,836	4,240	121,665	5.1%	3.8%	10.5%
6	121,665	2,433	7,300	4,867	2,433	1,715	89,200	3,969	4,394	126,532	5.9%	4.4%	10.7%
7	126,532	2,531	7,592	5,061	2,531	1,683	87,517	4,107	4,555	131,593	6.7%	5.0%	10.9%
8	131,593	2,632	7,896	5,264	2,632	1,651	85,866	4,252	4,722	136,857	7.5%	5.6%	11.1%
9	136,857	2,737	8,211	5,474	2,737	1,620	84,246	4,402	4,896	142,331	8.2%	6.1%	11.2%
10	142,331	2,847	8,540	5,693	2,847	1,590	82,656	4,559	5,078	148,024	8.8%	6.6%	11.4%
11	148,024	2,960	8,881	5,921	2,960	1,560	81,097	4,723	5,267	153,945	9.5%	7.1%	11.5%
12	153,945	3,079	9,237	6,158	3,079	1,530	79,566	4,894	5,464	160,103	10.1%	7.5%	11.6%
13	160,103	3,202	9,606	6,404	3,202	1,501	78,065	5,071	5,669	166,507	10.6%	8.0%	11.8%
14	166,507	3,330	9,990	6,660	3,330	1,473	76,592	5,257	5,882	173,168	11.2%	8.4%	11.9%
15	173,168	3,463	10,390	6,927	3,463	1,445	75,147	5,449	6,104	180,094	11.7%	8.7%	12.0%
16	180,094	3,602	10,806	7,204	3,602	1,418	73,729	5,650	6,336	187,298	12.1%	9.1%	12.1%
17	187,298	3,746	11,238	7,492	3,746	1,391	72,338	5,860	6,577	194,790	12.6%	9.4%	12.2%
18	194,790	3,896	11,687	7,792	3,896	1,365	70,973	6,078	6,828	202,582	13.0%	9.7%	12.3%
19	202,582	4,052	12,155	8,103	4,052	1,339	69,634	6,305	7,089	210,685	13.4%	10.0%	12.4%
20	210,685	4,214	12,641	8,427	4,214	1,314	68,320	6,541	7,360	219,112	13.8%	10.3%	12.5%

	Pre-JGTRRA	JGTRRA	Pre-JGTRRA Increase Over Fixed Income Trust	JGTRRA Increase Over Fixed Income Trust
Total After-Tax Distributions	95,075	105,997	31.4%	46.4%
Trust Balance After 20 Years	219,112	219,112	27.1%	27.1%
Trust Cost Basis After 20 Years	68,320	68,320		
If all Trust Securities sold at that time—Tax	30,158	22,619		
Would still leave remaining after tax assets of Total Net After Tax	188,954	196,494	9.6%	14%
After 20 Years	284,029	302,491	16.0%	23.6%

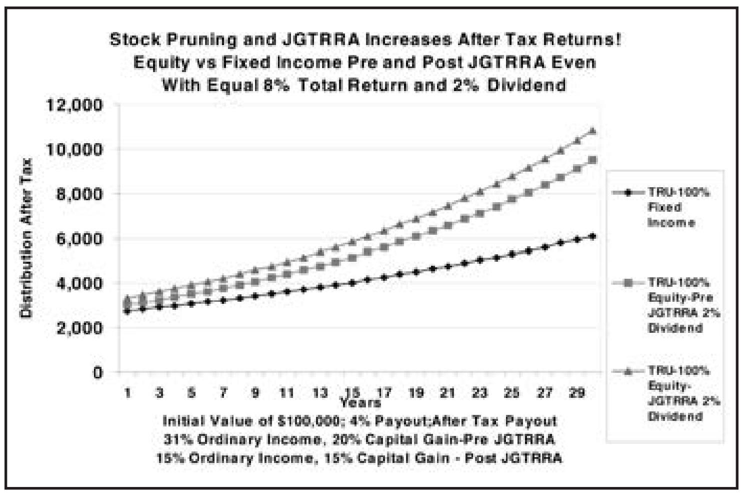
These dramatically improved results come as a result of several critical tax effects. The largest effect, particularly in the early years of the analysis, is the fact that the equity portfolio allows for tax deferral that applies to most of the gain in the stock values for the 20-year period. While the pre-tax distributions to the beneficiary begin as the same size as the distributions from the fixed-income total return trust, the equity TRU distributions are largely tax sheltered because each share of stock sold is entitled to use its individual per share cost basis. Thus, the original trust portfolio investment cost minimizes the amount of capital gain realized each year. In the first few years, the stock holdings which are pruned are primarily a recovery of the cost basis, so the effective tax rate is very low, 1.1% in the first year, prior to JGTRRA, and .8% after JGTRRA. If the process is continued long enough, the tax bracket would approach 20% prior to JGTRRA and 15% after JGTRRA, but as one can see, even after twenty years, the rate is still substantially discounted by the use of cost basis.[74] The cumulative after-tax distributions for the first twenty years are 31.4% larger prior to JGTRRA, even using the same total return from each form of investment.[75] The cumulative after-tax distributions taking JGTRRA into account are actually 46.4% higher than the taxable fixed income portfolio over a 20-year period. And at the same time, the equity TRU after twenty years has built up its value over 27% more than the fixed income model while wearing down its cost basis to a bit under $70,000.

In a QTIP trust, this capital gains tax would never be paid because it is includable in the life beneficiary's estate under I.R.C. Section 2044 and there would be a new cost basis at death.[76] Consequently, this type of investment program with pruning may be just as valuable for older trust beneficiaries as it is for young ones and in the marital trust as well as the credit shelter trust, where growth oriented investments are generally preferred.

But what if all of that deferred capital gain had to be recognized at the end? Would the trust be worse off with this "pruning" and the reduction of cost basis? Even if all of the trust securities that now had a relatively low remaining cost basis were sold at once and income tax paid, the after-tax assets would still exceed the value of assets under the fixed-income trust by 9.6% in the pre-JGTRRA world and 14% after JGTRRA. At the same time, the beneficiary would have received a huge increase in after-tax distributions by using the all equity trust with stock pruning.

Assuming a full payment of capital gains taxes at the end of the twenty year period, the total net after tax to the beneficiaries, including both after tax income and after tax corpus would be 16% greater before JGTRRA and 23.6% greater after JGTRRA.

The graph which follows shows the dramatic increase in after-tax income generated by the use of this stock pruning. In the first year there was 21% higher after-tax income prior to JGTRRA. But JGTRRA increases the benefit to over 33% in the first year! By the twentieth year the gap widens to over 41% in the pre-JGTRRA world and a 59% differential after JGTRRA. By the thirtieth year, the TRU approach pre-JGTRRA is producing 56% more after tax income while after JGTRRA the difference is an amazing 78%. Clearly, the longer the comparison goes on, the greater the difference the TRU approach, equity investing and capital gains makes to our income beneficiary. While some of our trusts continue far longer than this, perhaps the majority of them are likely represented by part or all of the following graph:



[74] Note that in this simple model, there is no turnover in the trust, except for that needed to pay the beneficiary her 4%. The portfolio is transparent, with no separate tax calculations inside the trust portfolio, expenses or other tax events that occur within the real trust portfolio, particularly one that is not a grantor trust. The author's computer model of historical returns does take the many complexities that actually occur in a real trust into account, and the effects of JGTRRA can be studied with this more refined model as well, but the effects will be similar, and in the same direction. Using historical returns has its limitations, however, particularly where the effect to be studied is a direct result of low dividend yields, which have only occurred very recently.

[75] This analysis implies the damage that occurs when equities are held in high-turnover mutual funds. If a fund with 100% turnover is used instead of individual stocks, almost all of this advantage is lost (leaving only the rate differential between 15% and the ordinary income tax rate). No deferral remains, and this deprives the investor of much of the 46% increase in value. *See* I.R.C. §1(h)(1).

[76] I.R.C. §1014(a).

The multiplication of after-tax income using the stock pruning TRU approach with equity investments, increasing the after-tax returns from 33% in year one to 59% in year twenty is a tremendous advantage of the total return trust pruning methodology and equity investing. Now all of these calculations would be rosy indeed were it possible to know in advance the returns and taxes on trust investments. And of course, we haven't taken into account the trust expenses, inflation, or the damage done by turnover in a trust portfolio. As will be demonstrated later in these materials, the higher the turnover, the more difficult it will be to accomplish the trust's objectives.

The multiplication of after-tax returns by the deferral of income taxes inherent in a low turnover equity portfolio is a surprisingly large factor, and JGTRRA increases those benefits in a material way, even in a lower return environment as illustrated above. Importantly, the preceding tables also assume that stocks and bonds have the same total return. Historically, this has never been the case over long periods of time. Once all of those points are considered together and taken into account, the results are truly dramatic.

C. FINAL REGULATIONS—WHAT WE NEEDED AND WHAT WE GOT

(1) But First, a Preliminary Word. The Proposed Regulations,[77] issued on February 15, 2001, were a remarkable achievement by the Treasury Department and the Internal Revenue Service. While they had been in the year 2000 business plan, they arrived while the first of the unitrust statutes were still being considered, and provided extremely useful guidance to practitioners, to the state legislatures and to state legislative advisory committees across the country concerning the all important tax effects of changing the state law definition of income. As a result, there was a torrent of legislation once the Proposed Regulations gave everyone a better sense about where Treasury stood on these new creatures—the power to adjust, and the power to convert to a unitrust. What were these questions, and what guidance did the Proposed Regulations provide?

1. First, and perhaps most importantly, a transfer to a trust for a spouse is required to distribute *all of the income* to the spouse during his or her lifetime in order to obtain the benefit of the gift and estate tax marital deduction.[78] Does a unitrust interest or an income interest subject to the power to adjust qualify for that all-important deduction?

2. Generally speaking, capital gains realized by a trust do not form a part of distributable net income that is passed out and taxed to the beneficiary. When might such realized capital gains be included in distributable net income and therefore passed out to the beneficiary in the context of the power to adjust and the non-charitable unitrust?[79]

3. How does the addition of the power to adjust or a conversion to a unitrust regime under state law affect the grandfathered status of older trusts for generation-skipping transfer tax purposes?[80]

4. How does a state law change to allow the power to adjust or a unitrust definition of income affect net income charitable remainder trusts and pooled income trusts under IRC Sections 664(d)(3) and 642(c)(5)?[81]

5. How does a state law change in the definition of income affect the tax treatment of distributions in kind?[82]

The answers to the first three questions were all favorable to the taxpayer seeking to employ modern investment techniques in a new or existing trust. The Proposed Regulations limit the effect of such changes in state law definition within the context of charitable split interest trusts, and required the recognition of gain and loss on the distribution in kind of assets in satisfaction of the obligation to distribute the new "income."[83]

---

[77] Proposed Reg-106513-00, Fed. Reg., February 15, 2001, Vol. 66, No.32, at 10396-10402 ("Proposed Regulations.").

[78] I.R.C. §§2523(e) and (f) and 2056(b)(5) and (b)(7).

[79] *See* Wolf 2, *supra* n. 27 at 153-154; Wolf Miami, *supra* n. 27 at I-C-47-I-C-48; J. Rosepink, "The Total Return Trust—Where and How to Tax Capital Gains," *Tr. & Estates* 12 (October 1998).

[80] *See* Wolf Miami, *supra* n. 27 at 102-103.

[81] Proposed Reg., *supra* n. 77, Explanation of Provisions at 10397-10398.

[82] *Id.* at 10398.

[83] For the most thorough review of the prior law and changes brought by the Proposed Regulations, *See* George L. Cushing, "Income Tax Treatment of 'Total Return Trusts,'" 2001 Annual Meeting Materials, American College of Trust and Estate Counsel, at B-1-GLC (2001).

There were other questions that the Proposed Regulations did not answer directly, which were commented on to Treasury. Among the most important were the following:

> 1. Would the exercise of the power to adjust or the conversion of an income trust to a unitrust constitute a taxable gift from someone to someone, since they both would seem to affect the economic value of the income interest?
>
> 2. Would the conversion of an income trust to a unitrust under a state statute be a sale or exchange under the so-called "*Cottage Savings*" doctrine?

Certainly the inference from the Proposed Regulations was that neither of these questions would be answered negatively where the exercise of the power to adjust or the power to convert was pursuant to a state statute within the parameters suggested in the Proposed Regulations, but more direct authority was needed to allow practitioners to be at ease with these issues. The *Cottage Savings* issue is of continuing interest, however, in a number of contexts, and is worth some discussion, even though the question is answered in this context by the Final Regulations provided that there is an applicable state statute within the direct scope of the Final Regulations.

One specific private letter ruling was chiefly responsible for the concerns of commentators in regard to the *Cottage Savings* doctrine. In PLR 200231011, decedent created a trust for his grandson, giving him an annuity interest for life, and leaving the remainder at his death to three charities.[84] Within a year after decedent's death, the trust was restructured with the consent of the court and the beneficiaries to provide annual income distributions to the grandson instead of the annuity set forth in the will, but with a minimum and maximum yield as specified in a "performance chart" agreed to by the parties, in part in exchange for partial payments from the trust to the charities. Differences arose among the parties as to the continued administration of the trust, and a global settlement was reached, whereby the charities' interests in the trust were cashed out, and grandson's interest in the trust was significantly reformed. He would now receive a 7% unitrust distribution; the trustee would have authority to distribute additional funds to him if needed for his "reasonable support." In addition, he was given a general power of appointment over the trust corpus exercisable by will, the latter inserted in order to obtain a favorable ruling for generation-skipping transfer tax purposes. Grandson then applied for a private letter ruling that there was no loss of GST exemption, that there was no taxable gift as a result of the transaction, and that the implementation of the proposed agreement and court order would not result in capital gain or loss or taxable income to any party to the order.

The ruling was favorable for purposes of generation skipping transfer tax, since the general power of appointment assured that no beneficial interest of a transfer to a skip person would be increased, nor the transfer extended.[85] The gift tax part of the ruling was also favorable, since the dispute and resolution of the differences concerning the interests of the charities and grandson were based on arms-length negotiations. But the income tax part of the ruling was highly unfavorable to taxpayer, holding that grandson's interest in the trust had been "exchanged" in a taxable transaction pursuant to *Cottage Savings Association v. Commissioner,* 499 U.S. 554 (1991). *Cottage Savings* involved the exchange of mortgage loans made to different obligors and secured by different homes that in the opinion of the court embodied sufficiently different legal entitlements that the taxpayer was entitled to realize losses when it exchanged interests in the loans.

The ruling contrasted *Evans v. Commissioner,* 30 T.C. 798 (1958) where an exchange was held to occur when the taxpayer exchanged her income interest in a trust for an annuity, with *Silverstein v. United States*, 419 F.2d 999 (7th Cir. 1969), where annual payments from a trust were exchanged for equivalent payments from the remainderman of the trust. The letter writer found the ruling request situation closer to *Evans* than to *Silverstein,* because taxpayer's interests in the trust were fundamentally changed from what they were previously. And indeed they were: Prior to the change on which guidance was requested, the taxpayer had an income interest with a maximum and a minimum in accordance with the performance chart, had no right to any additional principal, had no control over the property at his death, and shared his interest with the charities as parties in interest in the trust. After the modification he was the only party to the trust, he had a unitrust, rather than an income interest in the trust, the trustee was empowered to distribute additional portions of the trust as were needed under certain circumstances, and the trust was his to dispose of under his will. He really couldn't have

[84] The trust apparently was not a charitable remainder annuity trust, however.

[85] Treas. Reg. §2601-1(b)(4)(i)(D).

changed the character of his interest in the trust much more thoroughly. Other than the names, one would hardly recognize the new trust as being related to the old trust. The ruling held that the interest he received was a taxable exchange under Code Section 1001, and that since his interest was a term interest, he would have no basis in that interest under Section 1001(e)(1).

The question raised in the minds of commentators by this PLR is whether conversions to a unitrust under the express provisions of a state statute, and as approved in the Proposed Regulations, might be a gift or transfer or a sale or exchange under *Cottage Savings?* Could the mere passage of a state statute granting the trustee the power to adjust entail such a risk? Neither argument should hold water, in this author's opinion, but the issues will retain vitality in states where there is no unitrust conversion statute, and more broadly in the expanding context of trust modifications which are likely as the Uniform Trust Code[86] makes progress in state law. This PLR is highly distinguishable from a state law authorized unitrust conversion for the following reasons:

> (1) The effect of a unitrust conversion statute and a unitrust definition of income are to give the unitrust interest a legal equivalency. For example, under the Pennsylvania statute, after the conversion,
>
> "The term 'income' in the governing instrument shall mean an annual distribution (the unitrust distributions) equal to 4% (the payout percentage) of the net fair market value of the trust's assets, whether such assets would be considered income or principal under the provisions of this chapter [averaged over the lesser of the last three years, or the period during which the trust has been in existence]."[87]

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

> (2) Under the Proposed Regulations, a state law which allows an election into a unitrust definition of income should be respected for marital deduction purposes both for federal estate tax and gift tax purposes. The premise of the Proposed Regulations in this regard is that the marital interest is not affected in such a way that it is no longer a fair income interest entitled to the marital deduction and "consistent with the value of the trust corpus and with it's preservation."[88] So for this tax policy purpose, the marital interest, if converted into a unitrust interest, particularly within the range of 3-5% mentioned specifically in the Proposed Regulations, has not been diminished in such a way as to cause its character for tax purposes to be changed.
>
> (3) Under the Proposed Regulations, a state law which allows an election into a unitrust definition of income will not cause a previously grandfathered trust for generation-skipping transfer tax purposes to lose its grandfathered status. In Proposed Regulation 26.2601(b)(4)(i)(D)(2), the administration of a trust in conformity with a state statute that grants the power to adjust or the power to convert to a unitrust will not be deemed to constitute a shift of a beneficial interest in the trust.
>
> (4) Under the Proposed Regulations, if an income distribution is now defined as a unitrust interest or is subject to the power to adjust under applicable state law, and if that income dis-

[86] *See* Uniform Trust Code §§410, 417, 7C U.L.A. (2000). The Uniform Trust Code has been adopted in 15 states plus the District of Columbia at the time of this writing. *See* the NCCUSL legislative fact sheet at http://nccusl.org/Update/uniformactfactsheets/uniformacts-fs-utc2000.asp.

[87] 20 Pa.C.S. §8105(d)(3).

[88] *See* Treas. Reg. §20.2056(b)(5)(f)(1)(1994).

> tribution requirement is satisfied with property in kind, a gain or loss is realized by the trust under Proposed Regulation 1.661(a) 2-(f). Here again, and this time for income realization purposes, the unitrust interest is proposed to be the legal and tax equivalent of the prior income interest.[89]

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

It was therefore the author's opinion that it was highly unlikely that the reasoning of PLR 200231011 would be extended to attack a state law sanctioned unitrust conversion,[90] or the state law sanctioned power to adjust between principal and income. But we couldn't know that for sure until the publication of the Final Regulations.

The entire concept of applying the *Cottage Savings* doctrine to the modification of trusts is highly problematic from a technical and conceptual, as well as from a practical, point of view. If a unitrust conversion were a realization event, how would one measure the gain? Would it be based upon the actuarial value of the unitrust interest? And if so, even if there were a realization event, the beneficiary would not have received the value, and presumably would receive it for recognition purposes only a little at a time, each year, as an installment sale under Section 453.[91] And with those installments would presumably come imputed interest under Section 483 based upon the Applicable Federal Rates. And how would the trustee report the trust's income, deductions and distributions under Subchapter J? Would the beneficiary be taxed twice on the income, once as an installment sale with imputed interest, and once as a recipient of DNI? If not, where would the DNI go?

2. Treasury Gives Its "Final" Answers and Leaves Us with a Few Questions. On December 30, 2003, Treasury announced its Final Regulations governing the definition of income, largely affirming the Proposed Regulations, but with many additional points of clarification. [92] The Final Regulations represented the culmination of what was an unusually open exchange between practitioners, the Internal Revenue Service and Treasury. While the Final Regulations were a bit longer in coming than we might have thought likely after the Proposed Regulations were issued on February 15, 2001, Treasury obviously put the time to good use in considering the many comments submitted. The Summary provided with the Regulations is particularly helpful in discussing many of the comments submitted and why Treasury either did or did not embody them in the Final Regulations. These comments are very helpful in a number of areas in providing insight into the thinking and policy behind the Regulations. The Regulations are a very thorough and well reasoned response to a veritable sea change in the concept of "income".[93]

Overall, the Final Regulations clear up some major questions, give us guidance in some other areas, and leave certain areas largely untouched. In some areas, there are contradictions in the guidance they provided that will not yield to any amount of analysis.[94] But for the most part, the areas in which the Regulations are not clear are of far less importance than the areas in which they are clear, so we as practitioners, and those involved in the legislative process have a pretty good idea about what we can do and what we cannot do, and an educated guess about what is in between.

1. The Broad Picture—What We Know for Sure.

As previously described in detail in these materials, there are a total of 45 states plus the District or Columbia that have enacted total return legislation providing either the power to adjust under the Uniform Act, the power to convert to a unitrust or both.

The big question presented was whether the use of, or perhaps even the existence of, all of this state law change would be respected for federal tax purposes? Is it safe for a trustee to use these

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

[90] Barbara A. Sloan, "Consequences of PLR200231011: Cottage Savings or Cottage Industry?" 29 *ACTEC Journal* 102, 105, (Fall 2003).

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

[92] T.D. 9102, 69 Fed. Reg. 12 (2004).

[93] Robert B. Wolf and Steven R. Leimberg, "Total Return Trusts Approved By New Regs., but State Law Is Crucial," *Estate Planning*, April 2004 Vol. 31/No. 4, 179; Jonathan G. Blattmachr and Mitchell M. Gans, "The Final 'Income' Regulations: Their Meaning and Importance," *Tax Notes, Special Report,* May 17, 2004, 891, 895; Barbara A. Sloan, "§643 Regulations: Use of Non-Charitable Unitrusts and other Issues Raised under the Final Regulations," 30 *ACTEC Journal* 33, 46 (Summer, 2004); Linda B. Hirschson, "Final 643 Regulations Issued at Last Permitting Total Return Investing," *New York Law Journal,* May 1, 2004, *Trusts and Estates* Special Section 1.

[94] *See* Blattmachr and Gans, *supra* n. 93 for an exhaustive analysis of the Regulations, particularly with reference to the inclusion of capital gains in Distributable Net Income, at 898-907.

statutes? The Final Regulations resoundingly answer that question in the affirmative. So the conversion of a classic "hold the principal and pay the income" trust into a total return unitrust ("TRU") or a trustee's exercise of a power to adjust pursuant to a state statute will **NOT:**

1. Cause a loss of the federal estate tax marital deduction,
2. Trigger a taxable transfer for gift tax purposes,
3. Result in a taxable sale or exchange (ala *Cottage Savings*), or
4. Undo GST grandfathering.

Particularly with respect to trusts which were GST grandfathered, and for marital trusts, because the Proposed Regulations were not final and in effect, and by their express terms they could not be relied upon until the year after they were made final, much of the process of review and response had been delayed pending the final answers provided by the Regulations.[95] The reason for this is simple enough. The consequences of losing a marital deduction, or GST grandfathering, or the possibility of a sale or exchange treatment was sufficiently threatening that even a low level of concern was sufficient to keep many trustees from applying these new statutes to the majority of their existing trusts. The Final Regulations alleviated these concerns and protected the tax benefits under recent state law changes providing for a unitrust definition of income and/or the power to adjust between principal and income.

There are therefore no more reasons for trustees and practitioners not to fully implement the changes afforded by the legislatures of almost every state, and perhaps even more importantly, integrate a total return investment and distribution philosophy into their daily professional lives.

2. The Main Thing—The Final Definition of Income Under Section 643(b).

The most important change brought about by the Final Regulations is the change in the definition of income under Section 1.643(b)-1, which begins as follows:

> <u>1.643(b)-1 Definition of income</u>. For purposes of subparts A through D, part I, subchapter J, chapter 1 of the Internal Revenue Code, "income," when not preceded by the words "taxable," "distributable net," "undistributed net," or "gross," means the amount of income of an estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law. Trust provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized. For example, if a trust instrument directs that all the trust income shall be paid to the income beneficiary but defines ordinary dividends and interest as principal, the trust will not be considered one that under its governing instrument is required to distribute all its income currently for purposes of section 642(b) (relating to the personal exemption) and section 651 (relating to simple trusts). <u>Thus, items such as dividends, interest, and rents are generally allocated to income and proceeds from the sale or exchange of trust assets are generally allocated to principal</u>. (New language underlined.)

This first part of the Regulation reaffirms the statutory requirement that the tax law will recognize the meaning of "income" for Subchapter J to be that which is determined under the terms of the governing instrument and applicable local law, but trust provisions that depart fundamentally from traditional principles of income and principal will *generally* (the term is used quite a few times in the Regulations) not be recognized. The emphasized portion of the Regulation above is new language in response to comments that observe that the prior language, which talked of "ordinary income" and "capital gain" did not actually relate to state trust law concerning income and principal. Ordinary income and capital gain are tax concepts, not concepts of principal and income. The writers added some language to describe in a general way what is intended to be considered as "traditional principles of income and principal." The word "traditional" was newly inserted in the Proposed Regulations and was retained in the Final Regulation. The prior language was to exclude those notions which "depart fundamentally from concepts of local law,"[96] but local law has undergone an extremely thoroughgoing change with the advent of the unitrust and the power to adjust. It appears that the term "traditional" was inserted to allow the Service to reject local law which it thinks goes too far in redefining income in a way that might

[95] According to Suzanne Ross, former Senior Vice President of PNC Bank, N. A., her trust division had a total of 6,000 of such trusts upon which final decision had been delayed pending the Final Regulations.

[96] *See* discussion, Blattmachr and Gans, *supra* n.93, at 895.

be altogether too convenient and flexible to the taxpayer and the trustee.

But on with our income definition story. This portion of Regulation Section 1-643(b)-1 is the heart of the change in the law.

> However, an allocation of amounts between income and principal pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, including ordinary <u>and tax-exempt income</u>, capital gains, and appreciation. For example, a state statute providing that income is a unitrust amount of <u>no less than</u> 3% and <u>no more than</u> 5% of the fair market value of the trust assets, <u>whether determined annually or averaged on a multiple year basis</u>, is a reasonable apportionment of the total return of the trust. Similarly, a state <u>statute</u> that permits the trustee to make adjustments between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries is generally a reasonable apportionment of the total return of the trust. <u>Generally</u>, these adjustments are permitted by state statutes when the trustee invests and manages the trust assets under the state's prudent investor standard, the trust describes the amount that <u>may or</u> must be distributed to a beneficiary by referring to the trust's income, and the trustee after applying the state statutory rules regarding the allocation of <u>receipts and disbursements</u> to income and principal, is unable to administer the trust impartially. <u>Allocations pursuant to methods prescribed by such state statutes for apportioning the total return of a trust between income and principal will be respected regardless of whether the trust provides that the income must be distributed to one or more beneficiaries or may be accumulated in whole or in part, and regardless of which alternate permitted method is actually used, provided the trust complies with all requirements of the state statute for switching methods. A switch between methods of determining trust income authorized by state statute will not constitute a recognition event for purposes of section 1001 and will not result in a taxable gift from the trust's grantor or any of the trust's beneficiaries. 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. In addition, an allocation to income of all or a part of the gains from the sale or exchange of trust assets will generally be respected if the allocation is made either pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of a discretionary power granted to the fiduciary by applicable local law or by the governing instrument, if not prohibited by applicable local law. This section is effective for taxable years of trusts and estates ending after January 2, 2004.</u> (New language underlined.)

This new definition of income does a number of really important things:

a. 3% to 5% Unitrust Statutes Approved. It identifies as appropriate unitrust statutes that allow a 3% and 5% rate, or anything in between, and specifically allows the use of a multiple year smoothing rule, which is important because a three year smoothing rule is provided or allowed in all of the states with a unitrust conversion statute or a unitrust definition of income. Note that for such states, the unitrust amount is determined to be a reasonable apportionment of total return. There is no "generally" qualification.

b. Power to Adjust Statutes Approved. Perhaps concerned with differing state versions of the power to adjust, they retain the qualification from the Proposed Regulations that a state statute providing for the use of the power to adjust is "generally" a reasonable apportionment of total return. This isn't particularly comforting, but the qualification is likely inserted to curtail state law variations which differ substantially from the Uniform Act in their power to adjust, with which the Service has concluded that it is comfortable. The Final Regulation more helpfully inserted the word "Generally" before the description of the preconditions of the use of the power to adjust. Here, the Summary explains that because some states do not condition the use of the power to adjust on the trustee technically acting as a "prudent investor" or the lack of the word "equitable" in the state statute, should not prevent the power to adjust from being an acceptable exercise under the Regulations.[97]

c. Discretionary Trusts Included. The Regulations make it quite clear that sprinkle and spray trusts and other discretionary trusts which refer to "income" can be included in the new definitions of income.

d. No Sale or Exchange If Under State Statute. A switch between methods of determining income will not be a sale or exchange under Section 1001 and will not be considered a gift, provided it is done pursuant to the provisions of a state statute.

e. But If No State Statute, No Assurance. However, a switch in the method of determining income which is valid under state law, such as by a judicial decision, but is not pursuant to a state statute, may constitute a sale or exchange, or may constitute a gift.

f. Allocation of Gains to Income by Trustee Approved. Lastly, an allocation of gains from the sale of a capital asset to income will generally be respected if it is done pursuant to the terms of the governing document and applicable local law, or by the reasonable and impartial exercise of a power given to the trustee by applicable local law, or in the governing instrument if not prohibited by applicable local law. This means that one could grant the power to apportion gains to income, provided it were exercised reasonably and impartially and this power would not disqualify the "income," so defined, as income for federal tax purposes. This should not be confused with the power to adjust, however, since the Uniform Act and all state statutes of which the author is aware do not speak of the allocation of <u>gains</u> to income, but rather <u>principal</u> to <u>income</u>, and <u>income</u> to <u>principal</u>. It remains to be seen whether this last provision is going to be all that useful a provision, except perhaps in the context of a net income Charitable Remainder Unitrust, as discussed later.

3. What the New Income Definition Did Not Do.

The new Regulation did a lot, and answered a lot of questions in one overly long paragraph; but there are some important things it did not do:

a. State Statutory Authority Still Needed. Because the power to adjust is contained in a uniform act and particularly with respect to the unitrust where Treasury announced in the Proposed Regulations that it would respect a unitrust conversion statute that provided for the payment of a unitrust amount from 3% to 5%, a number of commentators[98] suggested that the payment of a unitrust amount between those boundaries should be acceptable to the Service even if there were no state unitrust statute. Here again, it is very helpful to see the reasoning provided in the Summary:

> Some commentators suggested that, even in those states that have not enacted legislation specifically authorizing powers to adjust or a unitrust definition of income, trust instruments containing such provisions should be respected as defining income for purposes of section 643(b)… <u>Accordingly, the IRS and the Treasury Department believe that an allocation to principal of traditional income items should be respected for Federal tax purposes only if applicable state law has specifically authorized such an allocation in certain limited circumstances, such as when necessary to ensure impartiality regarding a trust investing for total return. Under the regulations, a state statute specifically authorizing certain unitrust payments in satisfaction of an income interest or certain powers to adjust would satisfy that requirement</u>. Further, the IRS and the Treasury Department acknowledge that other actions may constitute applicable state law, such as a decision by the highest court of the state announcing a general principle or rule of law that would apply to all trusts administered under the laws of that state. However, a court order applicable only to the trust before the court would not constitute applicable state law for this purpose. (Emphasis inserted.)[99]

While the last sentence would allow applicable local law to add the power to adjust or the power to convert to a unitrust by a decision of the highest court of the state applicable to all trusts, this *Bosch*[100] standard is very

[97] 69 Fed. Reg. 12, 13 (2004).
[98] *See* Blattmachr and Gans, *supra* n. 93, at 897.
[99] *See* n. 97 *supra* at 13.
[100] *See* n. 63, *supra.*

unlikely to be met, since a state court is very likely to conclude that such a change in the law should be made by the legislature, and not the courts. And while they didn't say so in this context, there is Section 643(b) itself that states that "income" is to be "determined under the terms of the governing instrument and applicable local law." (Emphasis inserted.) On this point, this author thinks that Treasury had good grounds to insist on a high level of state law support, despite the fact that this adds confusion to the administration of trusts; particularly in light of the functioning of many corporate trustees in many different states. A consistent federal standard would be easier, but it would be less consistent with the language of the statute.

b. And Not Just Any State Statute—3% to 5% Is the Safe Harbor. Treasury approved of the trend in the unitrust statutes and what they understood about the power to adjust in the Uniform Act, but there was an overriding requirement for tax recognition that the statute provide for a "a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year." Two commentators suggested that any percentage provided by state statute should be O.K. but Treasury didn't take the bait, stating in the Summary: "The IRS and the Treasury Department believe that when establishing a unitrust percentage that attempts to yield the equivalent of income over a long period of time that may encompass wide variations in economic conditions, a range of 3% to 5% will be considered a reasonable apportionment of a trust's total return."[101] Treasury was obviously aware that while they were comfortable with the legislative trends which had altered the traditional notions of income and principal in a fundamental way, there were limits to that comfort. While there is nothing that states that a 2.8% unitrust or a 5.3% unitrust might not pass muster, unitrust statutes which provide for payouts of less than 3% or more than 5%, and unitrusts drafted in that manner, are simply not within the safe harbor of the Regulation.

c. What Did We and They Forget? How About a Trust Drafted as a Unitrust? In retrospect, we as commentators should have requested a clear reference in the Final Regulations to a trust that was drafted as a unitrust from the beginning in a state with a unitrust conversion statute. The author views this as more the fault of himself and other commentators than that of Treasury, since it is we, and not they, who have been drafting unitrusts, and in the case of the author, drafting them for quite some time. The problem is really two fold: First, do the state unitrust conversion statutes tie in sufficiently to the Final Regulations? And second, do our state statutes that do refer to unitrusts that are expressly drafted as unitrusts deal properly with the issue in this context? The Final Regulations require that for example, if there is a state statute which provides that income "is" a unitrust amount of not less than 3% nor more than 5%, then that amount will be considered to be "income" for federal tax purposes as well. In essentially all of the state statutes, "income" is defined as a unitrust amount if the trust is converted to a unitrust pursuant to the provisions of that statute. So, on a very literal and technical basis, if the trust were not a converted "income" trust, the state statute would not provide that the unitrust amount, even if defined identically with the unitrust amount for a converted income trust, is "income." Now the reason these conversions were the focus of all of our concern was that they were the ones that were causing the problem; the squeaky wheels, so to speak. After all, for future trusts, we could always draft the trusts as unitrusts and then provide for the payment of net income at least annually if the net income were greater than the unitrust. But we forgot to ask for explicit guidance on this point, and so we did not get it. It is submitted that it was not intended by the Regulation writers that in Pennsylvania and New York, which have unitrust conversion statutes with a 4% default rate, that a 4% unitrust would not qualify for the marital deduction—or that we would be forced to write the trust as an "income" trust and then convert it to a unitrust to bring it within our statute. And discussions with a representative of Treasury confirm this opinion,[102] but more official guidance would be helpful in this regard for those who want to be able to clearly define the legal support for their tax opinions (which includes the author). And those of us who participated in the drafting of these principal and income statutes should have considered dealing directly with the "express unitrust"; that is a unitrust that is drafted as a unitrust from the beginning. It is particularly clear in states, like Pennsylvania and New York, that while there may continue to be good reasons for selecting a default rate of 4% for income trusts which are converted, there is probably no good reason not to expressly condone by state statute the full 3% to 5% range expressed in the Final Regulations as permissible. After all, the reason for not selecting a range of payouts was to provide a point of reference and a legislative imprimatur on a distribution rate thought, on balance, to be fair. But reasonable minds can and do differ on the best rate to use, and there is no reason to

[101] *See* n. 97 *supra.*

[102] Cathy Hughes of Treasury was kind enough to discuss this with the author.

limit the freedom of the settlor of a trust to draft a 3% or a 5% unitrust, if that is their wish. And there are other matters, such as providing state law support for the treating of capital gains as part of a unitrust distribution or part of a distribution pursuant to the power to adjust or a discretionary principal distribution, which will be useful additions to our legislative menu. The next section following the detailed discussion of the Final Regulations discusses suggestions for legislative updates in light of the Final Regulations, with Delaware's amendment, once again the first in the nation, as a worthwhile template.

d. What Is "Income" in a Retirement Account Payable to a Trust? Questions Asked—Where a retirement account is payable to a trust, the issue of what portion of a distribution from the retirement account is "income" for trust accounting purposes can be particularly thorny. Some retirement benefits, such as from a defined benefit plan are simply a stream of retirement income. There is no discrete investment account or sum of money from which the income for that benefit is paid. The 1962 Uniform Act prescribed that for deferred compensation, 5% of the inventory value of the asset was income, and anything received in excess of that was principal. Since the inventory value would typically be the present value of the future income stream, the inventory value would depend upon interest rates at the time the asset was being valued.[103] That rule, while sharing a similarity or two with a unitrust rule, was viewed as too rigid, in light of the fact that the amount of the income did not change with the rise and/or fall of the amount actually distributed to the trust.[104] The "New" Act took a very different but perhaps even more rigid approach. Section 409 of the Act broadly applies to private, commercial and employer-paid annuities, deferred compensation, IRA's, profit sharing, stock bonus and other qualified plan benefits.[105] Section 409(b) provides that where payments from such a plan are characterized as interest or dividends, then they are to be treated as income for purposes of the trust as well, and the balance of such payments are principal. This provision, is, however, primarily to take into account plans such as ESOPs, which are required to make such distributions, and not the more common and important (from the point of view of estate planners) individual retirement accounts.[106] Section 409(c) provides the general rule for retirement account payments as follows:

> (c) If no part of a payment is characterized as interest, a dividend, or an equivalent payment, and all or part of the payment is required to be made, a trustee shall allocate to income 10 percent of the part that is required to be made during the accounting period and the balance to principal. If no part of a payment is required to be made or the payment received is the entire amount to which the trustee is entitled, the trustee shall allocate the entire payment to principal. For purposes of this subsection, a payment is not "required to be made" to the extent that it is made because the trustee exercises a right of withdrawal.[107]

In the context of the required minimum distribution regulations under Section 401(a)(9), this rule produces some very strange results. If the sole beneficiary of the trust is considered to be the surviving spouse of the participant, there is no required distribution at all until the deceased participant would have reached 70½.[108] And where there is a required distribution, the amount that is required is entirely dependent upon the age of the beneficiary, and not the "return," in any sense of the word, from the underlying investment assets in that retirement account. For example, a 20-year-old beneficiary has a life expectancy of 63 years, so that the required distribution would be 1.58% of the IRA balance as of the end of the prior year. Under the Uniform Act Rule, this would mean that .158% ($158 on $100,000) would be considered to be "income" from the IRA. A 63-year-old, on the other hand, would have a life expectancy of 22.7 years, and a required distribution of 4.4%, of which 10%, or .44% ($440 on $100,000) would be considered to be income. As Natalie Choate succinctly put it,

> [t]he amount of a required distribution from a retirement plan, under the rules of IRC Section 401(a)(9), has nothing to do with any traditional concept of income or principal of the plan.[109]

---

[103] Unif. Principal and Income Act, *supra* n. 11, §409, comment.

[104] *Id.*

[105] *Id.*, §409(a).

[106] Natalie B. Choate, "Trustees' Dilemma With Section 643," *Tr. and Estates,* 26, 27 (July 2004).

[107] Unif. Principal and Income Act, *supra* n. 11, §409(c).

[108] Choate, *supra* n. 106, at 28.

[109] *Id.*

This is a significant problem, because under the Final Regulations, in order for an amount to be treated as "income" it must either be income under traditional notions of income or principal, or, if supported by state statute, a non-traditional notion such as the unitrust or the power to adjust may be available if the approach is considered to be a reasonable apportionment of total return. And the regulations clearly define what they think is a "safe" distribution percentage, 3-5% when income is to be determined based upon the market value of the trust. In order for Section 409(c) to produce a distribution equal to 3% of the value of the retirement account, the beneficiary would have to be 98 years of age![110] Since the age of the beneficiary cannot have anything to do with what the investment "income" might be on an Individual Retirement Account in an economic sense, this 10% of the distribution rule seems very unlikely to qualify as "income" under the Final Regulations. If it does not qualify as "income" under the Final Regulations, then the IRA payable to a QTIP trust will not qualify for the marital deduction!

Fortunately, Section 409(d) provides a safeguard

> (d) If, to obtain an estate tax marital deduction for a trust, a trustee must allocate more of a payment to income than provided for by this section, the trustee shall allocate to income the additional amount necessary to obtain the marital deduction.[111]

The only difficulty with this provision is that it does not tell the trustee what to allocate in order to obtain the benefit of the marital deduction. The Comment to the rule does suggest that the trustee should look back to Revenue Ruling. 89-89, 1989 2 C.B. 231, (obsoleted by Rev. Rul. 2000-2, 2000-1 C.B. 305) which would direct that the income and dividends inside the IRA should be the amount that would define the income from an IRA distribution. In the opinion of this author, and others[112] the 10% rule simply did not qualify as income under Section 643, and hence would not qualify for the marital deduction without the safe harbor provision, which must take us back to the old rule or in a different, acceptable, direction. Will the saving provision and the power to adjust save the day, and the marital deduction?

Some uncertainty also arises where an IRA is payable to a trust that has been converted to a unitrust under applicable state statute. How is the "income" to be defined for the IRA payable to a unitrust? The approach first blessed by Revenue Ruling 89-89 and carried forward into Rev. Rul. 2000-2 treated the IRA as a separate trust, both for qualification and election purposes. Does the fact that a QTIP trust itself defines income as a unitrust amount carry over to the IRA? Does this happen automatically, or must there be supportive language in the trust, the IRA and applicable state law? Looking inside a separate account IRA or qualified plan itself to determine traditional "income" follows the Revenue Ruling 89-89 and 2000-2 approach, and is similar to that which has been incorporated into the Pennsylvania Principal and Income Act, discussed later. If consistent with obtaining the marital deduction, we might want to give the settlor or a trustee converting to a unitrust the option to prescribe either a unitrust approach for both the trust and the IRA, or maintain a traditional income and principal approach for that IRA. In the current investment climate, the use of a unitrust distribution payout of "income" will in some situations require a greater payout than might otherwise be necessary as a required minimum distribution or a distribution of "income" under traditional income and principal notions, and in those cases might be less desirable. In most cases involving the marital deduction, where the surviving spouse is elderly, the minimum required distribution is going to be more than a unitrust distribution of 3-5% and more than the "income" earned inside the IRA under traditional notions of income and principal.

e. What Is "Income" in a Retirement Account Payable to a Trust? Questions Answered—Revenue Ruling 2006-26. On May 4, 2006, the Service issued Revenue Ruling 2006-26,[113] superceding Revenue Ruling 2000-2 and addressing all of the federal tax questions raised in the previous section ("Ruling"). The Ruling addressed the situation of a 68 year decedent A whose IRA account was payable to a marital trust for A's spouse B for life, with the remainder passing to A's children at B's death. The Ruling recites that the IRA is currently invested in productive assets and B has the right (directly or through the trustee of Trust) to compel the investment of the IRA in assets productive of a reasonable income. The IRA document does not prohibit the withdrawal from the IRA of amounts in excess of the annual required minimum distribution amount under § 408(a)(6). The recitation of the foregoing provisions is likely important despite the favorable rulings discussed below for the unitrust and for the power to adjust, as they will need to stick around in our boilerplate for QTIP trusts and IRA beneficiary designa-

[110] *Id* .

[111] Unif. Principal and Income Act, *supra* n. 11, 409(d).

[112] Choate, *supra* n. 106, at 28.

[113] IRB 2006-22. May 30, 2006. 2006 C.B. ——: Currently available at http://www.irs.gov/pub/prs-drop/rr-06-26.pdf.

tions. Further, as in Rev. Rul. 2000-2, 2000-1 C.B. 305, the trust gives B the power, exercisable annually, to compel the trustee to withdraw from the IRA an amount equal to all the income of the IRA for the year and to distribute that income to B and requires the trustee to withdraw the greater of the income or the minimum required distribution, distribute the income to B and hold the excess, if any, in the trust as principal. "Under the trust instrument, no person other than *B* and *A's* children has a beneficial interest in Trust (including any contingent beneficial interest)." The trustee elects to take advantage of the exception to the five year distribution rule of Section 409(a)(9)(B)(iii) because all of the potential beneficiaries are individuals, and since B is the oldest, it is over B's life expectancy that the IRA must be withdrawn. Since distributions from the IRA in excess of the "income" is held in the trust, B is not considered the sole beneficiary for purposes of Section 409(a)(9)(B)(iv) allowing B to defer B's required distributions until A would have reached A's required beginning date. Again, this recitation underscores the problem of having to provide that all contingent beneficiaries must be individuals, and perhaps as well, that no contingent beneficiary shall take any share of the IRA who is *older* than B.

The Ruling sets out three situations for consideration under the above fact pattern:

1. **Power to Adjust State With Section 409(c) and (d).** The first situation is one in which the trust is governed by the laws of a state with the power to adjust "similar" to that set forth under Section 104(a) of the Uniform Act, and with the 10% rule and "savings" provisions "similar" to those provided under Section 409(c) and (d) of the Unifom Act.

2. **Unitrust State Law.** The second situation is one in which "Under State Y law, if the trust instrument specifically provides or the interested parties consent" the income of the trust means a unitrust amount equal to 4% of the value of the trust.

3. **Traditional Income and Principal Law.** The third situation is one in which the trust is governed by state law that has neither the Uniform Act with the power to adjust, nor a provision similar to Section 409(c) and (d), nor does it have the alternative unitrust definition of income.

All three scenarios are found to qualify for the marital deduction, provided that there are appropriate provisions in the trust, and the IRA. As to Situation 1, with the power to adjust, the Ruling provided that

> under section 104(a) of the UPIA as enacted by State X, the trustee of Trust allocates the total return of the assets held directly in Trust (*i.e.*, assets other than those held in the IRA) between income and principal in a manner that fulfills the trustee's duty of impartiality between the income and remainder beneficiaries. The trustee of Trust makes a similar allocation with respect to the IRA. The allocation of the total return of the IRA and the total return of Trust in this manner constitutes a reasonable apportionment of the total return of the IRA and Trust between the income and remainder beneficiaries under §20.2056(b)-5(f)(1) and §1.643(b)-1.

Since the income, once determined for the Trust and the IRA, is subject to the spouse's annual withdrawal right, it qualifies for the marital deduction. But what is the effect and interpretation of Section 409(c)?

> Depending upon the terms of Trust, the impact of State *X's* version of sections 409(c) and (d) of the UPIA may have to be considered. State *X's* version of section 409(c) of the UPIA provides in effect that a required minimum distribution from the IRA under Code section 408(a)(6) is to be allocated 10 percent to income and 90 percent to principal. This 10 percentallocation to income, standing alone, does not satisfy the requirements of §§20.2056(b)-5(f)(1) and 1.643(b)-1, because the amount of the required minimum distribution is not based on the total return of the IRA (and therefore the amount allocated to income does not reflect a reasonable apportionment of the total return between the income and remainder beneficiaries). The 10 percent allocation to income also does not represent the income of the IRA under applicable state law without regard to a power to adjust between principal and income. State *X's* version of section 409(d) of the UPIA, requiring an additional allocation to income if nec-

essary to qualify for the marital deduction, may not qualify the arrangement under §2056. Cf. Rev. Rul. 75-440, 1975-2 C.B. 372, using a savings clause to determine testator's intent in a situation where the will is ambiguous, but citing Rev. Rul. 65-144, 1965-1 C.B. 422, for the position that savings clauses are ineffective to reform an instrument for federal transfer tax purposes. Based on the facts in *Situation 1*, if *B* exercises the withdrawal power, the trustee is obligated under Trust's terms to withdraw the greater of all of the income of the IRA or the annual required minimum distribution amount under §408(a)(6), and to distribute at least the income of the IRA to *B*. Thus, in this case, State *X's* version of section 409(c) or (d) of UPIA would only operate to determine the portion of the required minimum distribution amount that is allocated to Trust income, and (because Trust income is determined without regard to the IRA or distributions from the IRA) would not affect the determination of the amount distributable to *B*. Accordingly, in *Situation 1*, the requirements of §2056(b)(7)(B)(ii) are satisfied. <u>However, if the terms of a trust do not require the distribution to *B* of at least the income of the IRA in the event that *B* exercises the right to direct the withdrawal from the IRA, then the requirements of § 2056(b)(7)(B)(ii) may not be satisfied unless the Trust's terms provide that State X's version of section 409(c) of the UPIA is not to apply.</u> (Emphasis inserted.)

And this would mean that section 409(c) and (d) do no good but do no harm, as long as we require the distribution of all of the "income" from the IRA to the trust and from the trust to the trust beneficiary, the surviving spouse *B*. In a state with the power to adjust, the Ruling infers a proactivity on the part of the trustee in allocating the total return of the trust and the IRA between income and principal in a manner which satisfies the duty of impartiality between the current and remainder beneficiaries. This explicit "income" distributions requirement could be set forth in the trust, or in both the trust and in the IRA beneficiary designation, depending upon one's preference for belts and suspenders. What we clearly cannot do is simply make the IRA payable to the marital trust and say nothing specific about the distribution of the income determined to be earned in the IRA, assuming that section 409(c) and a general direction in the trust to distribute the "income" will get it done.

Situation 2, applying a 4% unitrust statute to the Trust and to the IRA is held to qualify for the marital deduction without difficulty, but the interesting part is whether different definitions of "income" can be applied to the IRA and the trust into which it flows:

> The result would be the same if State *Y* had enacted both the statutory unitrust regime and a version of section 104(a) of the UPIA and the income of Trust is determined under section 104(a) of the UPIA as enacted by State *Y*, and the income of the IRA is determined under the statutory unitrust regime (or *vice versa*). Under these circumstances, Trust income and IRA income are each determined under state statutory provisions applicable to Trust that satisfy the requirements of §20.2056(b)-5(f)(1) and §1.643(b)-1, and therefore *B* has a qualifying income interest for life in both the IRA and Trust.

So the definitions of income can be different for the IRA and the assets held in the trust apart from the IRA, and this is so because the qualification of each is separate and does not depend upon the other. However, if the state law contains section 409(c), the provision must be completely ignored in the analysis, as it does not define the income earned in the IRA and is irrelevant as to the income earned in the trust.

Situation 3, where the state law uses a traditional definition of income without the power to adjust or the power to convert to a unitrust, the analysis would be the same, requiring the payout of income, or the right to demand the payout of income from both the marital trust and the IRA.

In all three of the Situations, the "income" of the IRA and the "income" of the rest of the trust are determined separately from one another, and the portion of the IRA payment to the trust which is considered "income" becomes irrelevant:

> In *Situations 1, 2, and 3*, the income of the IRA and the income of Trust (excluding the IRA) are determined separately and without taking into

> account that the IRA distribution is made to Trust. In order to avoid any duplication in determining the total income to be paid to *B*, the portion of the IRA distribution to Trust that is allocated to trust income is disregarded in determining the amount of trust income that must be distributed to *B* under §2056(b)(7).

So the Ruling completely eludes the problems presented by 409(c), while requiring the separate QTIP qualification for the trust and the IRA.

What does the Ruling imply as to the provisions of the marital trusts and the IRA beneficiary designations that we draw? Conservative practice will demand that the requirement that income be distributed or available for distribution on demand at least annually be placed in the trust, and it may not hurt to put it in the IRA beneficiary designation as well, though the latter may be only an additional precaution, reminding the IRA custodian of the requirement as well. It appears to be wise to continue to include a provision that the surviving spouse be able to demand that the trust and the IRA be invested so as to productive of a reasonable income. Now in the context of a unitrust, the "productivity" should not matter, but it seems unwise to take a chance that the Service would question the marital deduction on this basis since the recital of the fact is unbroken through the chain of Revenue Rulings. In addition, it is still required that nothing in the IRA or the trust may prohibit the trustee from withdrawing more than the minimum required distribution from the IRA.

Where we are free to choose a unitrust definition of income for the marital trust and a traditional definition of income for the IRA, subject to the power to adjust, this may be an attractive combination, because it may allow a smaller flow of distributions from the IRA than would be required from a unitrust distribution formula if the surviving spouse is relatively young (crossover point is 73 years of age for a 4% unitrust). However, this will predictably have the effect of reducing the income payout to the surviving spouse, so if a 4% distribution is desired from the marital trust including the IRA, it may be simpler to use the same definition of income in the trust and in the IRA.

The Ruling is stated to be prospective:

> Under the authority provided by §7805, the principles illustrated in *Situations 1* and *2* of this revenue ruling will not be applied adversely to taxpayers for taxable years beginning prior to May 30, 2006, in which the trust was administered pursuant to a state statute described in §§1.643(b)-1, 20.2056(b)-5(f)(1), and 20.2056(b)-7(d)(1) granting the trustee a power to adjust between income and principal or authorizing a unitrust payment in satisfaction of the income interest of the surviving spouse.

It is difficult to see how the Ruling would be applied to "taxable years beginning prior to May 30, 2006" in respect to its main holdings which concern the marital deduction. Perhaps the most sensible interpretation of the prospective nature of the Ruling is that the administration of the trust in taxable years after the death of a decedent but before the publication of the Ruling would not be used as ammunition to attack the marital deduction. Presumably, since the principles of the Ruling are not to be applied "adversely" retroactively, they might be relied upon if they support the taxpayer's position, even if the date of death was prior to the date of the Ruling's official publication on May 30, 2006.

One additional potential complication would be the question of choice of state law for an IRA or other retirement plan account, the agreement for which often purports to adopt the law of the state where the custodian has its primary offices. One would hope that a Pennsylvanian with a Fidelity Investments IRA would be able to use a unitrust definition of income under Pennsylvania law, despite Fidelity's selection of Massachusetts law in its IRA agreement. Work may still be needed to tie state law and beneficiary designations in as closely as possible to the Ruling, now that we have it.

f. How Do We Value an Income Interest Subject to the Power to Adjust or the Power to Convert to a Unitrust? One additional area that does not seem to have been addressed is how to correct and synchronize the method of valuing income interests in light of the power to adjust and the power to convert to a unitrust. If one converted an "income" trust to a 4% unitrust, would the value of the income interest change, or remain the same? If it did change, then does the value change only if the power is exercised or if it is merely possessed? An income interest normally is valued using the 7520 tables, so if the 7520 rate were 4.6%, then for a 50 year old beneficiary, the income interest would equal 68.7% of the whole. A 4% unitrust, on the other hand, would be valued at 64.1% for a Charitable Lead Unitrust if the payment were made annually (the same assumption that is used in the valuation of income interests). There is nothing wrong with the method of valuation of the unitrust, but of course the income interest is likely overvalued. This issue needs to be considered for a variety of purposes where the "income" interest must be valued, such as for the previously taxed property credit under Section 2013, under Section 2702 and otherwise.[114] It is ironic that the Final Regulations require that an alternative state statute produce a "reasonable apportionment between the income and remainder beneficiaries of the total return of the trust," while its own tax tables assume that the total return (the 7520 rate) is allocated entirely to the income beneficiary of the trust!

It is submitted that the power to adjust should not produce a similar problem with valuation, since the power in most cases, apart from a marital deduction trust, is a power to adjust either up or down, and therefore it should not in theory affect the valuation of the interest, even though at the present time it probably makes the income interest more valuable under current market conditions. And if it were to affect the value of the income interest, it is altogether uncertain how one could quantify that change in value in any event.

4. Much Discussion About Ordering and Capital Gains.

As contrasted with the relatively short portion of the new Regulations that deals with the core definition of income under Section 643(b), there is a lot more written about when capital gains can be included in distributable net income under Section 643(a), both in the Regulations themselves and in Commentary on the Regulations in the published articles on the Regulations.[115] What is more, there are *14* examples of when the Regulations allow capital gains to be included in DNI as opposed to *0* under the definition of income. For the most part, it is the author's opinion that the emphasis in and on this portion of the Regulations is overblown. First of all, the difference that having the power to adjust or the power to convert to a unitrust can be the difference between a payout of 2% from a trust and 4%, and the difference between having a 50/50 stock and bond asset allocation and having an 80/20 asset allocation. Any income beneficiary will tell you that doubling their income is a big deal, and any investment advisor worth her salt will say that the difference between an 80% equity and 20% bond portfolio and a 50/50 portfolio is likely to be huge over time. But whether the additional distribution to the current beneficiary pulls out with it capital gain as part of DNI will matter much, much less. We will examine the importance and effects of including capital gains in distributable net income in some detail later, but suffice it to say that the use of an "ordering rule" is more likely to be equivalent to a difference in payout rate of 25 to 40 basis points, not nearly the difference involved between a 2% payout and 4%! What it really reflects upon more than anything is the choice of an appropriate payout used by the unitrust or accomplished through the power to adjust. Clearly, if the capital gains are not part of DNI, it would be prudent to select a somewhat lower rate for a unitrust or for a transfer of slightly less principal to income under the power to adjust. Then too, the consequences of getting it wrong are less likely to be draconian than the loss of GST grandfathering, loss of the marital deduction or the treatment of a change in the definition of income as being a "sale or exchange" of the income interest under *Cottage Savings* discussed in detail previously.

b. The Regulation Itself. The regulation language itself is as follows:

> <u>1.643(a)-3 Capital gains and losses</u>.
>
> (a) <u>In general</u>. Except as provided in 1.643(a)-6 and paragraph (b) of this section, gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary.

So the general rule is as it always was since we began to wrestle with Form 1041. Capital gains are usually not part of Distributable Net Income.

> (b) <u>Capital gains included in distributable net income</u>. Gains from the sale or exchange of capital assets are included in distributable net income to the extent they are, pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law)—
>
> (1) Allocated to income (but if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of distributable net income determined without regard to this subparagraph 1.643(a)-3(b));

[114] *See* Blattmachr and Gans, *supra* n. 93, at 913.

[115] *Id.* at 900-907.

(2) Allocated to corpus but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or

(3) Allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary.

So there are three ways in which capital gains may be included in distributable net income, but in each case, there is a precondition relating to state law and the governing instrument. However, the structure of the sentence and its meaning is very difficult to parse. Capital gains can be included in distributable net income to the extent that they are

a. pursuant to the terms of the governing instrument <u>and</u> applicable local law, or
b. pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law <u>or</u> by the governing instrument if not prohibited by applicable local law.) (Emphasis added.)

This inconsistency between the language that applies to an ordering *rule*, as opposed to a discretionary ordering power was present in the Proposed Regulations, and was pointed out to Treasury in Comments:

> One commentator suggested that in the phrase "pursuant to the terms of the governing instrument and applicable local law," the term "and" be replaced with "or." The phrase with the term "and" is consistent with the statutory language of section 643(b), and, therefore, no change has been made.

Well, that sounds like a good answer, except that section 643(b) starts out by defining the word "income," as applicable when <u>not</u> preceded by the words, "taxable," "distributable net," "undistributed net," or "gross" means… And what we are describing here in not "income" but the composition of income for distribution purposes—distributable net income, which contains no such qualification:

> **§643(a)(3)** Capital gains and losses. — Gains from the sale or exchange of capital assets shall be excluded to the extent that such gains are allocated to corpus and are not (A) paid, credited, or required to be distributed to any beneficiary during the taxable year ...[116]

As between the Proposed Regulations and the Final Regulations, there was also a shift in the language of the second precondition applicable to discretionary powers:

> One commentator suggested that a discretionary power to allocate capital gains to income should not have to be exercised consistently. The exercise of the power generally affects the actual amount that may or must be distributed to the income beneficiaries and affects whether the trust or the beneficiary will be taxed on the capital gains. Thus, the IRS and the Treasury Department agree that the power does not have to be exercised consistently, as long as it is exercised reasonably and impartially. However, if the amount of income is determined by a unitrust amount, the exercise of this discretionary power has no effect on the amount of the distribution, but does affect whether the beneficiary or the trust is taxed on the capital gains. Under these circumstances, a discretionary power must be exercised consistently. One commentator suggested changing the phrase "if not inconsistent with local law" because powers to allocate capital gains to income will almost always be inconsistent with the default provisions of state law. Accordingly, the phrase has been changed to "if not prohibited by local law."[117]

Now this change the author thinks may cause some confusion. Literally, if capital gains are allocated to income, and income must be distributed, then of course the allocation has direct economic substance in that it goes to the income beneficiary, rather than staying in the trust. But changing the term to "impartially"

[116] I.R.C. §643(a)(3).

[117] *See* n. 97 *supra* at 14.

sounds like the language was borrowed from Section 104 of the Uniform Act, which in fact says nothing at all about allocation of capital gains to income or principal. While the tax effects of an adjustment are to be taken into account, no state law version of the power to adjust speaks to whether capital gain is included in distributable net income, nor requires that an adjustment from principal to income come from either proceeds or capital gain!

Commentators requested examples of how the rule would work in the application of the power to adjust, but the request was not granted. Again the Summary provides some insight:

> Two commentators requested examples of the inclusion of capital gains in DNI when the trustee exercises a power to adjust between income and principal under applicable local law. The circumstances in which a power to adjust is exercisable may vary among states and may be determined by the powers of the trustee to make distributions of income and principal under the terms of the governing instrument. For example, if a trust instrument does not permit the trustee to distribute any corpus and the power to adjust under local law may be exercised only with respect to receipts from the sale of trust assets, the amount allocated to income under the power to adjust may have to be from the realized appreciation in the value of the assets that were sold. On the other hand, if the trust instrument permits discretionary distributions of principal and the power to adjust under local law may be exercised only with respect to appreciation in the value of trust assets, the power to adjust may be similar to a unitrust amount that is payable irrespective of whether appreciated assets are sold during the year. Because of the potential variations in the circumstances and ramifications of exercising a power to adjust under applicable state statutes, additional examples would be unlikely to provide meaningful or complete guidance; thus, the final regulations contain no additional examples concerning inclusion of capital gains in DNI when the trustee exercises a power to adjust.[118]

What this author thinks all of that means is that where the power to adjust or a discretionary distribution power works like a unitrust, where the distribution is not contingent upon there being realized capital gain that is allocated to income and distributed, then a discretionary power is going to have to be exercised consistently, as is expressly required for a unitrust. If the exercise of discretion with regards to capital gain under the power to adjust and the governing instrument actually results in increasing the distribution to the beneficiary, then the exercise of discretion must be impartial, but not necessarily consistent year to year. This is the only way in which the foregoing makes sense within a tax perspective; that is, that where the inclusion in capital gains in income is merely a tax question of the composition of DNI, and does not affect what is distributed, it must be done on a consistent basis, because it is a tax accounting function, not an economic concept, and the Service is more sensitive to changes in accounting methods. But it seems to the author that the Service misapprehended the variety of power to adjust statutes out there. To the knowledge of the author, there is no state statute affecting private trusts that has varied the power to adjust so as to require that an adjustment of principal to income be from capital gain or appreciation, apart from the charitable endowment field, where the Uniform Management of Institutional Funds Act, a significant precursor to the total return trust movement, provides as follows in Section 2 of the Act:

> **SECTION 2. [Appropriation of Appreciation]** 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.[119]

[118] *Id.* at 16.

[119] Unif. Management of Institutional Funds Act, 7A Part II U.L.A. 475 (1999).

But the power to adjust has no such requirement, nor would such a requirement be wise, as it would cause problems for a trust portfolio that happens to start in a bear market, which would not allow the trustee to invest for total return until it had realized gains or at least experienced appreciation. So it is unhelpful that Treasury didn't give us guidance in this regard, and the summary leads one to think that the Regulation writers did not understand this important nuance of the Uniform Act. It is certainly possible that a trust document might contain such a provision, but it would be unusual.

What can we learn from the 14 examples provided by the Final Regulations? Example 1 reads as follows:

> Example 1. Under the terms of Trust's governing instrument, all income is to be paid to A for life. Trustee is given discretionary powers to invade principal for A's benefit and to deem discretionary distributions to be made from capital gains realized during the year. During Trust's first taxable year, Trust has $5,000 of dividend income and $10,000 of capital gain from the sale of securities. Pursuant to the terms of the governing instrument and applicable local law, Trustee allocates the $10,000 capital gain to principal. During the year, Trustee distributes to A $5,000, representing A's right to trust income. In addition, Trustee distributes to A $12,000, pursuant to the discretionary power to distribute principal. Trustee does not exercise the discretionary power to deem the discretionary distributions of principal as being paid from capital gains realized during the year. Therefore, the capital gains realized during the year are not included in distributable net income and the $10,000 of capital gain is taxed to the trust. In future years, Trustee must treat all discretionary distributions as not being made from any realized capital gains.[120]

The first thing we notice is that these rules are far broader than just the changes in the definition of income with the unitrust and the power to adjust. *They apply to ordinary discretionary distributions of principal as well.* Since the distribution of principal was made as an exercise of discretion which did not depend upon whether capital gains are included in income, the decision to not include capital gains in the $12,000 distribution of principal must be made consistently. Note that the last sentence in example 1 was added in the Final Regulations, so that the failure to include the capital gains in DNI will require a consistent treatment in future, just as would a decision to include the capital gains in DNI, which is illustrated by Example 2.

> Example 2. The facts are the same as in Example 1, except that Trustee intends to follow a regular practice of treating discretionary distributions of principal as being paid first from any net capital gains realized by Trust during the year. Trustee evidences this treatment by including the $10,000 capital gain in distributable net income on Trust's federal income tax return so that it is taxed to A. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must treat all discretionary distributions as being made first from any realized capital gains.[121]

Example 3 indicates that if a trustee "intends to follow a regular practice of treating discretionary distributions of principal as being paid from any net capital gains realized by Trust during the year from the sale of certain specified assets or a particular class of investments,"[122] that would be considered to be a reasonable exercise of discretion as well. This raises the possibility that if there is a particular class of investment, for example real estate, a closely held business, or even a very large block of a company's stock, for which it is desirable to have the capital gains taxed in the trust or to the beneficiary, that would be possible, though this discretionary power is extremely unlikely to be found in a trust instrument or for that matter in state law either at this point. It is a point where additional guidance by the service will be needed.[123]

Example 4 is quite important, in that it may shed light on the "and" versus "or" question:

> Example 4. The facts are the same as in Example 1, except that pursuant to the terms of the governing instrument

[120] Treas. Reg. §1.642(a)(3) ex. 1.
[121] *Id.* at ex. 2.
[122] *Id.* at ex. 3.
[123] *See* Sloan, *supra* n. 93, at 40.

> (in a provision not prohibited by applicable local law), capital gains realized by Trust are allocated to income. Because the capital gains are allocated to income pursuant to the terms of the governing instrument, the $10,000 capital gain is included in Trust's distributable net income for the taxable year.[124]

This example seems clear enough in providing that if the governing instrument requires that capital gains be allocated to income, as long as the provision to do so is not prohibited by applicable local law, then capital gain will be included in DNI. Commentators are not in agreement about what one takes from this Example. Some think that it is strong evidence that the governing instrument and applicable local law should be read together to determine whether the necessary requirement or authorization exists.[125] Others argue that the regulation does not specifically address the issue of what happens if the governing instrument, or applicable local law, but not both, direct that capital gain be part of income.[126] Still others would argue that "and" means "or" in this context.[127] This author believes that the determination would be made by examining local law and the governing document together and if the direction is in either, but not contradicted by the other, it should be followed and respected by the Service. This means that it would be respected if the document provided that distributions of principal would be deemed to include capital gain realized in the tax year, and state law was silent about it (as essentially all state law is, at the moment). And if state law said that it would be deemed to include capital gains and the document was silent on the matter (as essentially all trusts are, at the moment), it would be respected also. If, however, state law prohibited such a characterization, regardless of the governing instrument, it would not be respected even if the governing instrument so provided. If the governing instrument prohibited it, and state law merely allowed it, it would not be respected. But none of the foregoing suggests real meaning for the "and" in the Regulation apart from a reading of both together. And that of course is what we do in the trust law all the time. We read the trust, and if it covers a matter and is not prohibited by state law, that is the law as applicable to the trust. And if it is silent, we look at the state law to fill in the gaps. Is there something more eloquent really intended? This author does not think so.

Examples 5 and 6 illustrate that if the trustee uses the amount of capital gain realized to determine the distribution to the beneficiary, then the capital gain should be included in DNI. Again this makes sense in the more traditional analysis that if the amount of the capital gain determines what is paid out, then the distribution includes the capital gain in it. That, after all, is true for an allocation to income as well, where the income is required to be paid out to the beneficiary.

Example 11 helps flesh out the rule in the context of the total return unitrust:

> <u>Example 11</u>. The applicable state statute provides that a trustee may make an election to pay an income beneficiary an amount equal to four percent of the fair market value of the trust assets, as determined at the beginning of each taxable year, in full satisfaction of that beneficiary's right to income. State statute also provides that this unitrust amount shall be considered paid first from ordinary and tax-exempt income, then from net short-term capital gain, then from net long-term capital gain, and finally from return of principal. Trust's governing instrument provides that A is to receive each year income as defined under state statute. Trustee makes the unitrust election under state statute. At the beginning of the taxable year, Trust assets are valued at $500,000. During the year, Trust receives $5,000 of dividend income and realizes $80,000 of net long-term gain from the sale of capital assets. Trustee distributes to A $20,000 (4% of $500,000) in satisfaction of A's right to income. Net long-term capital gain in the amount of $15,000 is allocated to income pursuant to the ordering rule of the state statute and is included in distributable net income for the taxable year.[128]

This example could reflect a statute such as the Pennsylvania statute, which has an ordering rule that directs that the unitrust payout is to be paid first from income defined as if the trust were not a unitrust (this

[124] *See* n. 119, *supra* at ex. 4.

[125] *See* Sloan, *supra* n. 93, at 39.

[126] *See* Blattmachr and Gans, *supra* n. 93, at 901.

[127] *See* Blattmachr and Gans, *supra* n. 93, at 901, Professor Mark Ascher's view noted in fn. 29.

[128] Treas. Reg. §1.642(a)(3), ex. 11.

would be very similar, though not identical with "ordinary and tax-exempt income"),[129] and then from short-term gains, long-term gains and then the principal of the trust.[130] From the example, the governing instrument does not have the ordering requirement expressly stated, and yet the example says that is all right. Since two of the specific examples do not comport with the most literal and strict (and perhaps impractical) interpretation of the Final Regulations that would require an ordering rule to be in *both* state law *and* in the governing instrument, the author thinks that in this instance the word "and" is used to mean that the state law and the document should be read together. If the state law said something opposite from the governing instrument, or vice versa, then there is a question as to whether the ordering rule would be respected. But with Examples 4 and 11 to support us, it is most likely that silence in the governing instrument or the applicable local law, but not both, will not preclude an ordering rule from being respected.

And sound tax policy stands firmly in back of such an interpretation. Why should an ordering rule, which is obviously much less subject to manipulation than a power, be placed at a disadvantage?

Examples 12 and 13 assume the same facts as in example 11 (that is a 4% unitrust statute) but posit that if neither applicable state statute nor the governing instrument has an ordering provision, but "leaves such a decision up to the Trustee" the trustee's decision will be respected, provided the power is exercised in a consistent fashion. That all sounds sensible, but what does it mean for the state statute and the governing instrument to "leave" such a decision up to the Trustee? Is silence sufficient to do so? The author would argue that it is; that the powers of a trustee are otherwise plenary in the context of dealing with trust assets and the making of tax elections, perhaps in a fashion similar to the application of the 9th Amendment to the U.S. Constitution,[131] which implies that whatever rights are not expressly given to government are retained by the people. Hence the trustee retains those powers which are otherwise not addressed, provided that they are not against fundamental trust principals. Nevertheless, the author suggests strongly that states address this power directly in their statutes, as has been done by the overwhelming majority of states that have adopted unitrust statutes.[132]

Example 14 provides helpful clarification in noting that a trustee administering a number of trusts need not exercise its discretion consistently on the matter of whether to include capital gains in distributable net income.[133]

But what about the inclusion of capital gains in DNI pursuant to the exercise of the power to adjust? To the best of the author's knowledge, there is no state statute that grants the power to include capital gains in income as part of the power to adjust. And it is highly unlikely that the issue is addressed in the governing instrument in any appreciable number of cases. So unless the Service takes a liberal view of the state law requirement for this power or a very liberal view of tax apportionment language that might be found in documents, there will not be authority to use the power to consider capital gains as part of an adjustment of principal to income. This is unfortunate, in that including capital gains in DNI will allow a higher payout to be prudent, and may allow the beneficiary to offset trust gains against her personal capital losses. No doubt there will be exceptions, but it is almost always better to tax out the gains to the beneficiary. But the power to do that at the present time is highly uncertain.

If the power to adjust were to allow the trustee to include capital gains in DNI, must it do so consistently? Again we cannot be sure. As noted above, Treasury refused to provide any examples of the way the power to adjust might apply to allow the inclusion of capital gains in distributable net income, and commentators are split on the likely result.[134] The summary, it seems to this author, clearly indicates that the Regulation writers thought that the power to adjust could

[129] "Net income" would have the apportionment of trustee's fees applicable to it, whereas all of the trustees' fees would be deducted before determining the ordinary income and tax free income are part of DNI. Hence "net income" is generally greater than DNI because the income beneficiary gets the benefit of the deduction for all of the trustees' fees even though the majority of the fees may have been paid by the trust, and not deducted from the income account.

[130] 20 Pa. C. S. §8105(f)(2).

[131] "The enumeration in the Constitution, of certain rights, shall not be construed to deny or disparage others retained by the people." U.S. Constitution, Amendment IX.

[132] Only four states with a unitrust statute, Kentucky, New York, Missouri and Wisconsin, do not have either a tax ordering rule or a tax ordering power. Kentucky's statute is an unusual adaptation of the power to adjust which requires court approval for all adjustments, but expressly allows the power to be exercised in a unitrust manner. *See* the Table of Total Return Statutes set forth, *supra.*

[133] Treas. Reg. §1.642(a)(3), ex. 14.

[134] *See* Blattmachr and Gans, *supra* n. 93, at 905 and 906 advising that the result is uncertain, versus Professor Ascher at fn. 53 who apparently argues that capital gains would always be included in DNI in conjunction with an exercise of the power to adjust principal to income, and contrast with Sloan, *supra* n. 93, at 40 arguing that without some specific provision in the governing document, capital gain would not be part of DNI in connection with the power to adjust.

Calendar of Events

2006 Regional and State Meetings

Friday-Sunday April 21-23
Southern Regional Meeting
Place: Hilton Memphis, Memphis, Tennessee
Guest: Daniel H. Markstein, III, ACTEC President-Elect

Friday-Sunday April 28-30
Ohio State Meeting
Place: Inter-Continental Hotel, Cleveland, Ohio
Guest: Dennis I. Belcher, ACTEC Treasurer

Thursday June 8
Texas Dinner Meeting
Place: Houston, Texas
Guest: W. Bjarne Johnson, ACTEC Vice President

Monday June 12
Dallas ACTEC Fellows Luncheon
Place: Communities Foundation of Texas, Dallas, Texas
Guest: Karen M. Moore, ACTEC Secretary

Sunday June 18
Minnesota Fellows Dinner Meeting
Place: McNamara Alumni Center, University of Minnesota, Minneapolis, Minnesota
Guest: Daniel H. Markstein, III, ACTEC President-Elect

Tuesday June 20
New Jersey Annual Golf Outing and Dinner
Place: Fiddler's Elbow Country Club, Far Hills, New Jersey
Guest: Bruce S. Ross, ACTEC President

Friday-Saturday August 25-26
Florida Meeting
Place: Orlando Airport Hyatt, Orlando, Florida
Guest: Bruce S. Ross, ACTEC President

Friday-Sunday September 15-17
Rocky Mountain Regional Meeting
Place: Hotel Santa Fe, Santa Fe, New Mexico
Guest: Bruce S. Ross, ACTEC President

Friday-Sunday October 27-29
Mid-Atlantic Regional Meeting
Place: W Hotel, New York, New York
Guest: Bruce S. Ross, ACTEC President

Thursday-Sunday November 2-5
Southeast Regional Meeting
Place: The Sea Pines Resort, Hilton Head Island, South Carolina
Guest: Bruce S. Ross, ACTEC President

In Memoriam

William H. Engelbrecht
Waverly, Iowa

Ian Michael Blandford Jameson
Toronto, Ontario

Cecilia I. Johnstone
Edmonton, Alberta

Joseph F. Maier
Cheyenne, Wyoming

Charles E. Rains
Tulsa, Oklahoma

Roelif Jansen Randerson
San Diego, California

Dean A. Rich
Pinehurst, North Carolina

Francis M. Richards
Philadelphia, Pennsylvania

Roy D. Stewart
Racine, Wisconsin

Any gift to the ACTEC Foundation made in the memory of a deceased Fellow will be acknowledged to the family.

2006 Summer Meeting

July 6–9, 2006
Los Angeles, California

The 2006 ACTEC Summer Meeting will be held at the Millennium Biltmore Hotel Los Angeles, a landmark celebrating over 80 years of tradition. Since its opening in 1923, this hotel has been home to presidents, kings and Hollywood celebrities. Its central location in the downtown business district provides a convenient inner-city retreat for guests, including a full array of services, health club facilities and the old-world charm and elegance of a great European hotel. It has been recently renovated and restored to its original glory.

Downtown Los Angeles has lots to offer! We will have tours of the Frank Gehry-designed Disney Concert Hall, downtown's historic Art Deco-style architecture, and Warner Bros. Studios, among others. Our welcome event will be spectacular—a very casual (no ties or sports coats allowed) outdoor party at famous Pershing Square. There will be a fabulous band playing at one end of the square for dancing, with seating at the other end of the square for dinner and quiet conversation. We turn formal on Saturday night, when we move inside to the famous Crystal Ballroom at the Biltmore. Before dinner, we will be treated to a concert featuring the music of Mozart by principal players of the Los Angeles Chamber Orchestra.

We hope you will have time for some extra special pre- and post-meeting tours that just don't fit into the main meeting schedule.

Further information regarding hotel reservations and our unique tours in the City of the Angels was sent to you in May. A tentative schedule is below.

Dates:	Main meeting dates—Thursday, July 6 through Sunday, July 9, 2006 Catalina Tour—Wednesday, July 5 Pasadena Tour—Sunday, July 9 through Tuesday, July 11
Place:	Millennium Biltmore Hotel Los Angeles, California (213) 624-1011
Wednesday July 5	All-Day Outing to Catalina Island
Thursday July 6	Committee meetings— As scheduled in the afternoon
Tours	Architectural Tour at Caltech, the Gamble House and Other Historic Houses The Getty Center Tour—private docent tours of architecture and gardens and audio self-guided tours of the galleries.
Evening	Dinner for Committee Chairs, speakers and their spouses/guests (by invitation only) LA Dodgers vs. San Francisco Giants
Friday July 7	Professional Program—Where the Rubber Meets the Road—Pesky Practice Problems Encounter Practical Solutions
Morning	Committee meetings— as scheduled throughout the day
Morning Tours	Books at Breakfast with the Author *Jamesland* by Michelle Huneven Hooray for Hollywood Tour LA's Art Deco Architecture Tour
Afternoon Tours	Warner Bros. Behind the Scenes Tour LA's Contemporary Architecture Tour
Evening	I LOVE LA—President's Welcome Dinner at Pershing Square for all Fellows and spouses/guests
Saturday July 8	Committee meetings— as scheduled throughout the day
Morning Tours	Circa Nineteenth Century Tour LA's Art Deco Architecture Tour (repeat)
All-Day Tour	La Brea Tar Pits Tour
Evening	From the Classics to Cabaret: An Elegant LA Evening at the Biltmore (Optional event; black tie optional) Featuring members of the Los Angeles Chamber Orchestra LA Dodgers vs. San Francisco Giants
Sunday July 9	Committee meetings — as scheduled in the morning "The Artful Teapot" Revisited
Sunday July 9 to Tuesday July 11	Post-meeting trip: Museum/Garden Tour of Pasadena— The "Tournament of Roses" City

2006 Fall Meeting

October 12–16, 2006
Providence, Rhode Island

This October we journey to Providence, Rhode Island, during leaf-peeping season. The Westin Providence, ACTEC's headquarters hotel, with its glass-domed rotunda, red brick tower and stately décor, reflects New England's charm and heritage. Our overflow hotel, the Providence Biltmore, was recently restored to its original grandeur. Both hotels are located very close to each other and to all that the city has to offer. They are just 10 miles (about 15 minutes) from T. F. Green Airport (PVD) and less than an hour's drive from Boston.

"A Lucky Unlucky Night" is our welcome event on Friday the 13th at Dave and Buster's. This sophisticated, state-of-the-art arcade, ours for the evening, offers great food and drink, with fun games for everyone from 5 to 95. Our Saturday night costume ball will be held in the Biltmore's Grand Ballroom on the 17th floor, featuring excellent food and wine and great views of the city lights below.

We are planning some very special tours, including Benefit Street's "Mile of History," the most impressive concentration of original Colonial homes in America. Providence features fine art museums and lots of outdoor activities—you can glide down the Providence River in a gondola in the heart of the city, cycle along the bike paths or go kayaking on Rhode Island's beautiful waterways. We will take you to Mystic, Connecticut, for a behind-the-scenes tour of the fabulous Mystic Aquarium and a visit to historic Mystic Seaport. For added New England charm, join us on a trip to Blithewold, a 17th-century manor house and gardens set on Narragansett Bay. And you cooks won't want to miss a cooking demonstration followed by a visit to Johnson & Wales, a renowned culinary school whose graduates ensure a wealth of fine dining opportunities in Providence.

If you can come on Sunday, October 8, you won't want to miss our pre-meeting trip to Newport for tours of its truly magnificent mansions and museums, a private clambake and more. A tentative meeting schedule is below. Further information regarding the meeting, hotel reservations and the pre-tour will be sent to you in June.

Dates:	Thursday, October 12 through Monday, October 16, 2006
Place:	The Westin Providence/ Providence Biltmore Providence, Rhode Island
Sunday October 8 to Wednesday October 11	Special Pre-Meeting Tour to Newport, "America's First Resort" Spend several wonderful days with ACTEC friends and get an overview of this exciting city-by-the-sea.
Thursday October 12	Committee meetings— as scheduled throughout the day
Tours	Blackstone Valley Riverboat Cruise with Museum of Work and Culture
	Cooking Class and Culinary Tour of Providence
	Providence City Tour
Friday October 13	Professional Program— to be announced
	Spouses/Guests Program— to be announced
Tours	Blithewold and Audubon Society
	Providence Walking Tour
	Providence Houses of Worship
Evening	President's Welcome Reception at Dave & Buster's "A Lucky Unlucky Night" For all registered Fellows and spouses/ guests—as scheduled in the evening
Saturday October 14	Professional Program— to be announced
	Committee meetings— as scheduled in the afternoon
Tours	Mystic Aquarium Behind-the-Scenes/ Historic Mystic Seaport
	Providence Walking Tour (repeat)
	Cycling in the East Bay Region
	Rhode Island Art Tour
Evening	Costume Ball at the Biltmore Optional event for all Fellows and spouses/guests—as scheduled in the evening
Sunday October 15	Committee meetings— as scheduled in the morning
Tours	Coastal RI Lighthouses
	Kayaking Adventures
	Cycling in the East Bay Region (repeat)
	Cooking Class with Chef Walter
	State Chairs Meeting
Evening	Cocktails and Dinner for Regents, Regents Emeriti, State Chairs, and their spouses/guests
Monday October 16	8 a.m. to adjournment Board of Regents Meeting

ACTEC National Meeting Schedule

	ANNUAL	SUMMER	FALL
2006	**Wednesday–Monday** **March 8–13** Grand Wailea Resort Maui, Hawaii (*March 6**)	**Thursday–Sunday** **July 6–9** Millennium Biltmore Hotel Los Angeles, California	**Thursday–Monday** **October 12-16** The Westin Providence/ Providence Biltmore Providence, Rhode Island
2007	**Wednesday–Monday** **March 7–12** The Westin Kierland Resort & Spa Scottsdale, Arizona (*March 5**)	**Thursday–Sunday** **June 28–July 1** The Grand America Hotel Salt Lake City, Utah	**Thursday–Monday** **November 1–5** The Greenbrier White Sulphur Springs, West Virginia
2008	**Wednesday–Monday** **March 5–10** Boca Raton Resort and Club Boca Raton, Florida (*March 3**)	**Thursday–Sunday** **June 26–29** The Coeur d'Alene Resort Coeur d'Alene, Idaho	**Thursday–Monday** **October 23–27** The Westin Savannah Harbor Golf Resort & Spa Savannah, Georgia
2009	**Wednesday–Monday** **March 4–9** The Westin Mission Hills Resort Rancho Mirage, California (*March 2**)	**Wednesday–Saturday** **June 24–27** The Fairmont San Francisco San Francisco, California	**Thursday–Monday** **October 15–19** The Williamsburg Inn and The Williamsburg Lodge Williamsburg, Virginia
2010	**Wednesday–Monday** **March 10–15** Hyatt Regency Coconut Point Resort and Spa Bonita Springs, Florida (*March 8**)	**To be determined**	**To be determined**
2011	**Wednesday–Monday** **March 9–14** Arizona Biltmore Resort and Spa Phoenix, Arizona (*March 7**)	**To be determined**	**To be determined**

* Committee members' early arrival

Highlights of the 2006 ACTEC Annual Meeting

by M. Read Moore

Chicago, Illinois

The 2006 Annual Meeting, from March 6 through March 13, took place at the Grand Wailea Resort in Maui, Hawaii. There were 492 Fellows and 386 spouses and other guests in attendance, for a total of 878. Among the Fellows attending were 62 first-time attendees. Although Hawaii experienced an almost unprecedented amount of rain this winter, the rain miraculously bypassed this Annual Meeting, which made for an enjoyable week of educational programs, College business and fun social events with a tropical Hawaiian flavor. Despite the temptations of Maui, most of the Fellows managed to attend at least some committee meetings and seminars.

Annual Meeting of the College

Judy McCue presided at the Annual Meeting of the College on Thursday, March 9. As part of the meeting, the following Regents were elected to a second term on the Board of Regents:

Peter S. Gordon	*Wilmington, Delaware*
Ellen K. Harrison	*Washington, D.C.*
Linda B. Hirschson	*New York, New York*
Jerry J. McCoy	*Washington, D.C.*

Seven Fellows of the College were elected to a first term on the Board of Regents:

Monica Dell'Osso	*Oakland, California*
Erin Donovan	*Tulsa, Oklahoma*
Charles D. "Skip" Fox, IV	*Charlottesville, Virginia*
Noel C. Ice	*Fort Worth, Texas*
Michel G. Kaplan	*Nashville, Tennessee*
Joshua S. Rubenstein	*New York, New York*
Irving S. Schloss	*New Haven, Connecticut*

Richard B. Gregory (*Las Cruces, New Mexico*) was appointed to fill the unexpired term (2 years remaining) for Karen M. Moore.

Annual Meeting of the Board of Regents

The Board of Regents met on March 13 and elected the following officers of the College for 2006-2007:

President:
- Bruce S. Ross — *Los Angeles, California*

President-Elect:
- Daniel H. Markstein, III — *Birmingham, Alabama*

Vice President:
- W. Bjarne Johnson — *Great Falls, Montana*

Treasurer:
- Dennis I. Belcher — *Richmond, Virginia*

Secretary:
- Karen M. Moore — *Columbus, Ohio*

Immediate Past President:
- Judith W. McCue — *Chicago, Illinois*

The Board of Regents also confirmed the election of the officers as directors of the ACTEC Foundation. In addition, these Fellows were elected as directors of the Foundation:

For a second three-year term:

Joseph J. Hanna, Jr.	*Portland, Oregon*
Rodney N. Houghton	*Vero Beach, Florida*
Daniel H. Markstein, III	*Birmingham, Alabama*
Stephen E. Martin	*Idaho Falls, Idaho*
Clare H. Springs	*San Francisco, California*

For an initial three-year term:

Karen M. Moore	*Columbus, Ohio*
Edward J. Beckwith	*Washington, D.C.*
Steve A. Brand	*Minneapolis, Minnesota*
Carol A. Harrington	*Chicago, Illinois*
Susan T. House	*Pasadena, California*
Susan K. Smith	*Phoenix, Arizona*

For an initial two-year term:

Donna G. Barwick	*Atlanta, Georgia*
Leonard J. Prekel	*Troy, Michigan*
Jay A. Travis	*Jackson, Mississippi*

For an initial one-year term:

Cynda C. Ottaway	*Oklahoma City, Oklahoma*
Mary F. Radford	*Atlanta, Georgia*
Robert D. Taisey	*New York, New York*

The Board of Regents elected each of the following Fellows to a one-year term as a director of Convention Coordinators, Inc. (CCI):

Robert J. Durham, Jr.	*San Diego, California*
Carlyn S. McCaffrey	*New York, New York*
Ronald D. Aucutt	*McLean, Virginia*
Robert J. Rosepink	*Scottsdale, Arizona*
Judith W. McCue	*Chicago, Illinois*

W. Thomas Coffman (*Tulsa, Oklahoma*), chair of the Membership Selection Committee, reported that 26 candidates were recommended. Tom completed his term as committee Chair and Susan T. House (*Pasadena, California*) will succeed Tom as Chair of the committee.

Neill McBryde (*Charlotte, North Carolina*), President of Convention Coordinators, Inc., reported on matters relating to the selection of future meeting sites. Neill concluded his term as President at this meeting. Carlyn McCaffrey succeeded Neill as President.

Joseph Trachtman Lecture

Malcolm A. Moore (*Seattle, Washington*) gave an interesting lecture on the history of estate planning lawyers that spanned several centuries, from the middle ages in England to colonial America. The lecture was a welcomed break from the usual discussion of current tax and trust law issues and gave all in attendance an excellent perspective on, as Mal put it, "the origin of our species." This was Mal's second Trachtman Lecture; he delivered his first Trachtman Lecture in 1981 at the Annual Meeting in Tarpon Springs, Florida.

Passing of the Gavel

At the dinner-dance on Saturday, March 11, Judy McCue gave a short speech thanking those who supported her during her term as President and highlighted the accomplishments and work of many others on behalf of the College. Bruce Ross, in accepting the gavel as President, thanked Judy for the time and effort that she gave the College during her year as President and her other efforts as an officer over the years.

Athletic Events

A number of athletic events were held during the Annual Meeting. Awards were presented at the dinner-dance.

Golf

Low Gross:

Women	Men
Jami Pebbles (89)	Lee Moore (78)
Judith Duffy (91)	S. Lewis Perlson (78)
Carol Nabor (93)	Robert Saalfield (78)

Low Net:

Women	Men
Lynn Waterman (64)	Richard Klobucher (52)
Nancy Wolov (67)	Terry Slye (57)
Lynn Bigley (70)	James Lestikow (61)

Emerald Course

Closest to the Pin:

Women	Men
Meg Gaynor	Jeffrey Chang

Longest Drive:

Women	Men
Pam McCullogh	Lew Perlson

Gold Course

Closest to the Pin:

Women	Men
Lynn Bigley	Tim Meinhart

Longest Drive:

Women	Men
Rita Kaplan	Steve Johnson

J. Nicholas Shriver, Jr. Memorial Trophy:

Randall Yee

10th Annual John L. Sullivan Fun Walk/Run

	Women	Men
1st Place	Margaret Hand	Charles Riley
2nd Place	Lynn Moore	Gary Bjelland
3rd Place	Carol Wachter	Scott Martinson

New Officer, Regents, State Chairs and Committee Chairs

SECRETARY

Karen M. Moore is a partner with the 150-lawyer Ohio law firm of Bricker & Eckler LLP, where she has been employed for the past 31 years. Karen chairs the Tax, Trusts and Estates Department of the firm. She currently serves as Secretary and Trustee of the Columbus Symphony Orchestra and is active in a variety of capacities with the Ohio State Bar Association. Her husband, Ed, is a bond lawyer with Bricker & Eckler LLP. Daughter Tracy is pursuing a Ph.D. in physics at the University of Maryland at College Park, and son David graduated from Washington University in St. Louis.

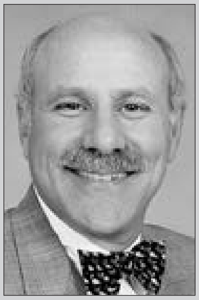
REGENTS

Monica Dell'Osso is a member of Burnham Brown, a 55-lawyer firm in Oakland, CA. She has practiced with the firm for almost 25 years. Monica serves on the Advisory Committee of the UCLA/CEB Estate Planning Institute. She is a Trustee Emerita of St. Mary of the Woods College, IN, and is active in several civic and charitable organizations. In her spare time, she enjoys running, biking and classical music. She is a member of the Board of Directors of Legal Assistance for Seniors and the Planned Giving Advisory Committee for KQED, a public television station.

Erin Donovan recently established a solo practice. She has served as President of the Trusts and Probate Section of the Oklahoma Bar Association and is a member of the Tulsa Title and Probate Lawyers Association and the Tulsa Estate Planning Forum, having been a past Vice-President. Erin is a past President and current Advisory Board member of Family and Children's Services of Oklahoma, a Board member of Birthright of Tulsa and a member of the Tristesse Grief Center Board. Erin volunteers as a program presenter for the Oklahoma Council for Community and Justice, just completing a year as a member of Leadership Oklahoma. She is on the Planned Giving Council for the Catholic Diocese of Eastern Oklahoma and volunteers at the Neighbor for Neighbor free legal clinic. Erin has a fifteen-year-old son who is a high school freshman.

Charles D. (Skip) Fox, IV is a partner in the Charlottesville, VA, office of McGuireWoods LLP, a national law firm with 750 attorneys in 13 U.S. and 2 overseas offices and 21 attorneys in its Private Wealth Services Group. Prior to joining McGuireWoods in 2005, Skip practiced for 25 years with Schiff Hardin LLP in Chicago. Besides ACTEC, Skip serves on the boards of several charities, including the University of Virginia Law School Foundation. He previously taught at Northwestern University School of Law for over 20 years. He is married to Beth, a retired trust officer, and they have two sons, Quent (age 13) and Elm (age 11).

Noel Ice is a partner at Cantey & Hanger, L.L.P. (founded in 1882, it's the oldest law firm in Fort Worth/Dallas and one of the oldest in Texas). Noel graduated from the University of Texas at Austin, with a B.A. with honors and from the University of California, Hastings College of the Law, J.D. As a Fellow with of the American College of Trust and Estate Counsel, he currently serves on the Board of Regents and is Texas State Chair. He is a member of the American Bar Association, licensed to practice law in Texas in 1976, admitted to practice before the United States District Court, Northern District of Texas; the U.S. Court of Appeals, Fifth Circuit and U.S. Tax Court. Having been listed among America's Best Lawyers in many publications, Noel is the author of numerous articles and a frequent speaker in tax law, employee benefits law and trusts and estates. A wine connoisseur, Noel is a student of history, philosophy and literature who also enjoys hiking, bicycling, fishing and traveling.



Michel G. Kaplan is a member of Sherrard & Roe, PLC, Nashville, TN. Mike received both his undergraduate and law degrees from Vanderbilt University. He holds an LL.M. (in Taxation) from New York University. Prior to entering private practice, Mike served as attorney-advisor to the Honorable Samuel B. Sterrett, Judge of the United States Tax Court, Washington, D.C., from 1972 through 1974. He is a member of the Tennessee Probate Study Committee of the Tennessee Bar Association. He practices in the area of estate planning and administration, taxation, and tax exempt organizations. Mike is on ACTEC's Charitable Planning and Exempt Organization Committee, as well as the Strategic Planning Committee.

Joshua S. Rubenstein is an adjunct professor at Brooklyn Law School and is the author of the *LexisNexis Answer Guide on New York Surrogates Court Practice.* He is listed in *Best Lawyers in America, Chambers,* Best Lawyers in New York by *New York Magazine,* Best Lawyers in America by *American Lawyer,* Top 100 U.S. Attorneys by the *Robb Report, Worth Magazine,* and Top 100 International Wealth Advisors and Top 100 Wealth Advisors, Americas by *Citywealth.* Josh received his B.A. in Greek and Latin, *magna cum laude,* from Columbia University, where he was elected to Phi Beta Kappa, and his J.D. from Columbia University Law School, where he was a Harlan Fiske Stone Scholar. He is an Academician and Trustee of the International Academy of Estates and Trusts Law (IAETL), a Fellow and Regent of the American College of Trust and Estate Counsel (ACTEC), a Member of the U.K.-based Society of Trust and Estate Practitioners (STEP), and a Fellow of the New York Bar Foundation. He is a former Chair of the Trusts & Estates Law Section of the New York State Bar Association and of the International Committee of the Real Property and Probate Section of the ABA. Josh is also extremely active in the community, holding positions including Vice President of the Jewish Board of Family and Children's Services, Trustee and past President of the Irvington Institute for Immunological Research, and a member of the professional advisory councils of numerous prominent charities.

Irving S. Schloss is a partner at Tyler Cooper & Alcorn, LLP in New Haven and Madison, CT. He has practiced with his firm for 35 years. The firm has 75 lawyers in its four offices. Irv is currently a member of the Executive and Steering Committees of the Connecticut Bar Association's Estates and Probate Section and former Chair of the CBA's Business Law Section. He has spoken and written frequently on estate planning issues. Irv's wife, Deborah Abildsoe, is an investment manager with her own firm. They co-authored *Understanding TIAA-CREF,* published by Oxford University Press. Both enjoy cycling and cross-country skiing. Daughter Tracy is entering her final year at the University of Michigan Law School, and son David will start Wheaton College this fall.

STATE CHAIRS

Tom D. Womack *(Arkansas)* is a principal in the law firm of Womack, Landis, Phelps, McNeill & McDaniel, P.A., with 16 attorneys in Jonesboro, AR. His practice includes trusts, estates, taxation and business planning. He has served as Chair of the Section of Taxation and the Section of Probate and Trust Law of the Arkansas Bar Association and as a member of the Tax Law Specialty Committee of the Arkansas Board of Legal Specialization. Tom is listed in *The Best Lawyers in America* in Trusts and Estates and in Tax Law and is a frequent presenter at estate planning, tax and planned giving seminars and has written for professional publications. Tom and his wife, Linda, a college mathematics instructor, have two sons: Drew, a manager in Tennessee with a national building materials company, and Derek, a graduate student at the University of Miami.

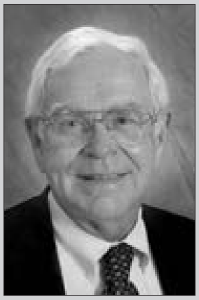
Kenneth A. Feinfield *(California)* is in the Los Angeles office of Freeman, Freeman & Smiley LLP and is a member of their Estate Planning and Probate/Trust Administration Department, where he heads the Post-Mortem Trust Administration Department. He is a Certified Specialist in Estate Planning, Probate and Trust Law by the State Bar of California, Board of Legal Specialization. Ken has taught numerous courses on the subject of the administration and taxation of decedent's Trusts and Estates for California Continuing Education of the Bar (CEB), as well as numerous other institutions and organizations. In 2004, 2005 and 2006, Ken was named a "Southern California Super Lawyer," representing the top 5% of the practicing attorneys in Southern California, as selected by his peers in an extensive nomination and polling process conducted by *Law and Politics* and published in *Los Angeles Magazine.*

Kevin D. Millard *(Colorado)* joined with ACTEC Fellow Marc Chorney last fall to form Chorney & Millard LLP, in Englewood, CO (a Denver suburb). Kevin limits his practice to estate planning, probate, trust administration and transfer taxation. Kevin is the immediate past Chair of the Trust & Estate Section of the Colorado Bar Association and is active on a number of T&E section committees. His wife, Cate, is a high school Spanish teacher. They have four daughters: Elizabeth, a Ph.D. in molecular biology, who is now a first-year law student with plans to practice intellectual property law; Lesanne, a graduate student in landscape architecture; Sarah, a college undergrad; and Angela, a California free spirit.

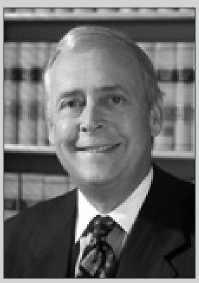
Milford B. Hatcher, Jr. *(Georgia)* has been a partner of Jones Day for 17 years. He is in the Atlanta office of Jones Day, a firm with over 2,000 lawyers and 29 offices in the United States and abroad. Mil currently serves as Vice Chair of ACTEC's Estate and Gift Tax Committee. He previously was the lead counsel for ACTEC in regard to the *Kimbell* and *Strangi amicus briefs* and was the Chair of the Tax Section of the Georgia Bar. Mil is a member of the Board of the Medical College of Georgia Foundation and is Chair of the Investment Committee and a member of the Executive Committee. He aspires to be a much better golfer and investor, but is challenged in regard to both and thus remains an active practitioner, speaker and writer. His wife, Aileen, is a C.P.A. and has been actively involved as a member of the board of numerous charities.

Richard D. Woods *(Kansas)* is a shareholder in the Kansas City law firm of Kirkland & Woods, P.C., which he co-founded in 2001 after 25 years with Shook, Hardy & Bacon LLP. Dick practices in Kansas and Missouri. Currently, he is a member of the ACTEC Technology Committee and the Eastern Kansas Estate Planning Council. He is active in the community, currently as Chair of The Family Conservancy and Secretary of Gilda's Club Kansas City. Dick has served as Treasurer of the North Kansas City School District, Chair of the North Kansas City School District Educational Foundation, Director of the Estate Planning Association and the Estate Planning Society of Kansas City, and Chair of the Planned Giving Committee of Truman Medical Center Foundation. Dick and his wife, Mary Linna, have six children between them, ranging from 17 to 26—all of whom have attended the University of Kansas (five at one time for a semester). He enjoys computer games and golf when he can find the time.

Nancy G. Fax *(Maryland)* is the managing partner of the 16-lawyer firm of Pasternak & Fidis, P.C. in Bethesda, MD. Nancy has served on ACTEC's State Laws Committee for several years. She is Chair of the Section Council of the Estate and Trust Law Section of the Maryland State Bar Association and is former Chair of the Estates, Trusts and Probate Law Section of the District of Columbia Bar. Nancy founded *The District of Columbia Estates, Trusts and Probate Law Digest*, where she served as Editor for many years. Nancy was recent Chair of the Montgomery County Community Foundation, which is an affiliate of the Community Foundation for the National Capital Region. Nancy shares her life with Christopher Richardson, who teaches math and French and coaches soccer at an independent school. Nancy's daughter, Joanna, is a high school English teacher in Brooklyn, and her son, Ben, just completed his second year at McGill University in Montreal. In addition, Nancy has two stepchildren, Lauren, who is a teacher in Detroit, and Peter, who enjoys outdoor sports by day and bartends by night.



James H. LoPrete *(Michigan)* has been a part of the Monaghan, LoPrete, McDonald, Yakima, Grenke & McCarthy law firm since 1954. The firm has practiced in the trust and estates area throughout Michigan since its founding in 1902. Jim is a member of the ACTEC Fiduciary Litigation Committee and has been recognized by the Michigan Court of Appeals as an expert witness in T & E litigation. He is past Chair of the Probate and Estate Planning Section of the State Bar. Jim and his wife, Marion Garry, have four children: James, a dentist; Kimberly, a lecturer in Medical Studies at the National University of Ireland Galway; Kent, manager of Strategic Planning Delphi Corp.; and Robert, an attorney. Jim and Marion have five grandchildren. Son Rob is a newly elected ACTEC Fellow from Chicago. In addition to his active practice, Jim manages various charitable foundations and supports local educational and cultural organizations. His philosophy is that an active practice and life keep the mind and body young!



Richard R. Burns *(Minnesota)* is a senior partner in the firm of Hanft Fride, a Duluth, MN, law firm of 18 attorneys. Richard has been with Hanft Fride for 30 years. He regularly represents small- and medium-sized family businesses in generational, tax and general business matters, as well as corporate and individual fiduciaries. Richard also acts as General Counsel for Morgan Murphy Stations, a family-owned broadcast media company with four affiliated television stations and 12 radio stations in Wisconsin, Iowa, Washington and Idaho. He is currently a trustee at Northland College, Ashland, Wisconsin, and a member of the University of Michigan Law School Committee of Visitors. Richard is a former Chair of the Duluth-Superior Area Community Foundation and the United Way of Greater Duluth. He and his wife, Liz, split their time between their Duluth, Minnesota, and Carefree, Arizona, offices.

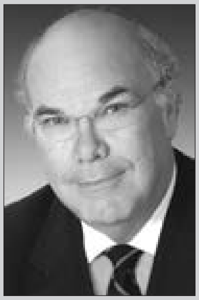
Daniel N. McLean *(Montana)* is a partner in the Helena, MT, branch office of Crowley, Haughey, Hanson, Toole & Dietrich P.L.L.P., where his special expertise is in elder law issues. He is past President of the Yellowstone Valley Estate Planning Council, past Chair of the Tax and Probate Section of the State Bar of Montana, past President of the First Judicial District (Montana) Bar Association and a former Vice Chair of the Elder Law Committee of the American Bar Association General Practice Section. Dan currently serves as a Trustee of the State Bar of Montana, is a member of the State Bar of Montana Elderly Assistance Committee and serves on the boards of Montana Legal Services Association and Lewis and Clark County Community Foundation. Dan enjoys playing golf, fly-fishing, reading and brewing beer. Dan and his wife, Marcy, have three almost-grown children: Christina, 23, who lives in Reno, Nevada; Katie, 20, a student at Loyola University Chicago; and Jim, 17, who will graduate from high school in 2007.

James M. Maddox *(New Mexico)* is President of Maddox & Holloman, P.C., a general practice law firm with five attorneys in Hobbs, NM. In addition to his estate planning and probate practice, he spends a significant amount of his time working as an executive officer and director of a family foundation in Hobbs. Among his community activities, Jim currently serves as Chair of the Endowment Trust Fund of the Boys Scouts of America (Conquistador Council) and as Chancellor (general counsel) for the New Mexico Annual Conference of the United Methodist Church. Jim is the past President of the New Mexico Methodist Foundation and has served in various leadership roles with the local United Way, Boys and Girls Club and his local church. He enjoys biking and snow skiing. He and his wife, Sue, have been married for 38 years and have three children. Tom is a cardiology fellow at Mount Sinai Medical Center in NYC. John is a pediatrician in Wilmington, MA. Catherine teaches 1st grade in Midland, NC (near Charlotte). They have one grandchild, Jack, a 7-year-old hockey player.

Linda B. Hirschson *(New York)* is a shareholder with the New York City office of Greenberg Traurig LLP. The firm has over 1,500 attorneys and lobbyists throughout the United States and Europe. Linda is a member of the New York EPTL-SCPA Legislative Advisory Committee. As such, she was the principal draftsperson of New York's current right of election law and the Optional Unitrust Provision component of New York's current Principal and Income Act. Linda is a past Chair of the Trusts and Estates Law Section of the New York State Bar Association. She also is a past Chair of the Transfer Tax Study Committee of

ACTEC. Linda currently is serving as the Chair of the Professional Advisors Council of the Metropolitan Museum of Art in New York City. Linda and husband Al have two children: Jay received his MBA from Columbia Business School; Pam received her MBA from NYU's Stern Business School. Pam is also the mother of Linda and Al's 6-year-old grandchild, Caitlyn.

Christy Eve Reid *(North Carolina)* is a shareholder in the Charlotte office of Robinson, Bradshaw & Hinson, P.A., a 120-lawyer firm with offices in both Carolinas. Christy has served on the Board of Governors of the North Carolina Bar Association and as Chair of its Estate Planning & Fiduciary Law Section. She is a past Chair of the North Carolina Board of Legal Specialization and a past President of the Charlotte Estate Planning Council. Christy currently serves on the ACTEC Fiduciary Income Tax Committee, several NC Bar Association committees and on the Board of Trustees of Charlotte Christian School. Christy and her husband, Scott, a business owner, have three children: Lauren, a veterinarian; Ian, a graduate student in seminary; and Olivia, a college senior.



Benjamin G. Paster *(Rhode Island)* is a principal of Paster & Harpootian, Ltd. in Providence, RI (the only "all ACTEC" firm in the state), where he has practiced for ten years. They represent only two types of clients: old money and new money! Ben received his B.Sc. (Economics) from the Wharton School (University of Pennsylvania) and law degrees from Cambridge (England) and Yale. He is past President of the Estate Planning Council of Rhode Island. Active in community affairs, Ben is past Chair of the Miriam Hospital Foundation and serves on numerous charitable boards. He and his wife, Linda, live in Cranston and have a daughter, Nicole, who is pursuing a Ph.D. at the University of California, Berkeley.

W. Steven Johnson *(South Carolina)* is a partner at Todd & Johnson, L.L.P. in Columbia, SC. He earned his B.A. (English) from Wofford College and his J.D. from the University of South Carolina School of Law. Steve has served as Chair of the South Carolina and Richland County Bar's Estate Planning, Probate and Trust Law Section. He is honored with being listed in the Trusts and Estates specialty field of *The Best Lawyers in America.* Steve is currently a member of the Specialization Committee for Estate Planning, Probate & Trust Law for the State of South Carolina. He has lectured frequently and has co-authored a section of Chapter 3, Choosing Fiduciaries, *Estate Planning in South Carolina.* Steve is married to Patricia. They are both active members of St. Martins-in-the-Fields Episcopal Church, where Steve has served as Treasurer and as Senior Warden of the Vestry.

Dan W. Holbrook *(Tennessee)* is a founding partner in the Knoxville estate planning boutique firm of Holbrook & Peterson, PLLC, currently with eight lawyers. Licensed in Florida as well as Tennessee, Dan writes a regular column on estate planning for the *Tennessee Bar Journal*, has served for two decades on a statewide blue ribbon panel reviewing and drafting legislation related to state property law, probate and taxation. He has also served on numerous nonprofit boards. When not spending time with wife Mary, two adult sons and two grandsons, Dan can be found running trails in the woods of Tennessee.

Robert H. Leonard *(Wyoming)* has been a member of the Laramie, WY, five-attorney firm of Prehoda, Leonard and Janack, LLC for 11 years. Bob received his J.D. from the University of Missouri and LL.M. (tax) from George Washington University. He chaired the Wyoming Estate Planning Advisory Council, which drafts trust and estates legislation for Wyoming and was a drafter of the Wyoming version of the Uniform Trust Code. Bob is a former Air Force judge advocate, having served as an area defense counsel, staff judge advocate, trial judge and appellate judge. He is a member of Rotary and Kiwanis and is past President of Kiwanis, the Eppson Center for Seniors Foundation, the Albany County Chapter of the American Red Cross, and the Wyoming Retired Officers Association. Bob is married to Carmen Cores-Castro of Pontevedra, Spain; they have three children: Julie, Daniel and Christopher. He enjoys snow skiing, biking and running.

Timothy G. Youdan *(Ontario, Canada)* is a partner in the law firm of Davies Ward Phillips & Vineberg LLP, Toronto, Canada. He received a B.A. from Cambridge University and an LL.M. from the University of Toronto. Tim was called to the bar in England in 1971 and in Ontario in 1979. As well as being an ACTEC Fellow, Tim is a member of the Canadian Bar Association, the Canadian Tax Foundation, the International Academy of Estate and Trust Law, the Society of Trust and Estate Practitioners and the Estate Planning Council of Toronto. Tim was formerly a chancery barrister in England and a law professor at the University of Western Ontario and at Osgoode Hall Law School of York University. He has been a part-time teacher at Cambridge University, and he was a visiting Fellow of Trinity College, Cambridge, and of St. Catherine's College, Oxford.

COMMITTEE CHAIRS

Nancy S. Roush *(Business Planning Committee)* is a partner in the Kansas City office of Shook, Hardy & Bacon L.L.P., a firm of approximately 500 attorneys with worldwide offices. Nancy has been with the firm over 19 years and in practice for over 25 years. She specializes in business planning for privately owned companies, including large professional firms, and estate planning for individuals. Nancy has been active in the Kansas Bar Association, including serving as the Chair of the both the Estate Planning and Tax sections of the bar, editor of the probate handbook and lecturer. She has twice received their Outstanding Service Award. Nancy is also active in local politics and charitable organizations. She enjoys gardening and, of course, attending ACTEC meetings. She and her husband, John, have a daughter, Jessica, who is currently a freshman at the University of Kansas.

Carlyn McCaffrey *(President, Convention Coordinators Inc.)* is a partner in the New York City law firm of Weil, Gotshal & Manges LLP. The firm has a total of 793 attorneys, 12 of whom practice primarily in the areas of estate and personal tax planning and trust and estate administration. Prior to joining the firm 31 years ago, Carlyn was an assistant professor at New York University Law School, where she is currently an adjunct professor. She is a member of the New York State Bar Association and the Association of the Bar of the City of New York. She and her husband, John, have four children: John, an attorney; Patrick, an aspiring actor; Jennifer, a developer of children's television programs; and Kathleen, a literary agent.

Susan T. Bart *(Editor, ACTEC Journal)* is a partner in the Private Clients, Trusts & Estates Group of the Chicago office of Sidley Austin LLP. She authored the book *Education Planning and Gifts to Minors* and co-authored the award-winning *Illinois Estate Planning Forms and Commentary*. Susan also writes a monthly Q & A column for MorningstarAdvisor.com on their website entitled "529 Advisor." Susan earned a Juris Doctor degree, *magna cum laude* (Order of the Coif), in 1985 from the University of Michigan Law School, where she was Articles Editor of the *Michigan Law Review*. She is a member of the Board of Directors and Secretary of the Illinois Institute for Continuing Legal Education. She is also a member of the Board of Trustees of Roosevelt University, a member of the Board of Directors of the Domestic Violence Legal Clinic (which provides legal services to victims of domestic violence), and a member of the Board of Directors and Secretary for The Next Theatre in Evanston, Illinois.

Robert St. John *(Elder Law Committee)*, a graduate of Yale (B.A., LL.B.), practices in a broad range of commercial litigation areas. He has significant experience in commercial, trust and estate and employment litigation in state and federal courts. Bob has achieved the highest Martindale-Hubbell rating. Listed in *The Best Lawyers in America* under Banking Law, Corporate Law and Real Estate Law, Bob has received many distinguished service awards in New Mexico, including the Pro Bono Project Award, while serving on the Advisory Opinions Committee (Chair), the Committee on Women and the Profession (Co-Chair), the Lawyers Care Pro Bono Advisory Committee (Chair), the Committee on Legal Services and Programs, the Supreme Court Code of Professional Conduct Committee and the Supreme Court Self Represented Litigants Working Group. Bob is a Fellow of ACTEC, the American College of Real Estate Lawyers and the American College of Mortgage Attorneys.

Barbara A. Sloan *(Fiduciary Income Tax Committee)* has been a partner in the 55-lawyer New York City law firm of McLaughlin & Stern, LLP since 2000. She is an adjunct professor in the Graduate Tax Law program of the NYU School of Law. Barbara is active in local and national bar associations, serving as past Chair of the Estate and Gift Tax Committee of the Tax Section of the ABA and as a member of the Council of the Real Property, Probate and Trust Law Section. She is on the Board of the NYU Institute on Federal Wealth Taxation and serves on professional advisory councils for the New York Public Library, the Simon Wiesenthal Tolerance Center, the New York Philharmonic Orchestra and the Museum of Art and Design. She also serves on the Boards of the Eye Bank for Sight Restoration, the Kaufman Center and the New Group. Barbara's daughter, Felicity, teaches ninth grade English at the Brentwood School in Los Angeles, where she also is faculty advisor for the yearbook.

Robert W. Goldman *(Fiduciary Litigation Committee)* of Goldman Felcoski & Stone P.A. of Coral Gables/ Naples, FL, waxes poetic:

To satisfy your résumé request,
I've reduced me to verse.
Take heart, you could have made
me sing it, which would've been
far, far worse.

I received my B.A. from the University of Miami
When it had no basketball team and its football team
was a bit sloppy...
To Tallahassee I went to learn the law
And before FSU found me out, it signed me out
(J.D., Florida State University).

With B.A. and J.D. to boot
My children marvel and wonder
At the complete void beneath my roots
And my eccentric blunders.

I impress them with Bar Associations
and Courts a plenty;
The Supreme Court of United States,
the Florida Bar, among many.
Still, they are more impressed with my pancakes
And the myriad of ways in which I can be silly.

Undaunted, I force them to see
I am past Chair of Real Property, Probate & Trust
Law Section of The Florida Bar;
I am Past Chair of Florida Probate Rules Committee;
Past Chair of Guardianship Law Committee;
Past member: Probate Law, Professionalism;
and Legislation Committees of the Real Property,
Probate & Trust Law Section of The Florida Bar.
But at these they just yawn
And point out I'm a bore...

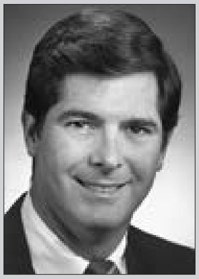
But wait, little rascals, there's much, much more!
Currently, I am a member of, Probate Law, Trust Law,
and Probate Litigation Committees, and Chair of a
committee with a name no one can pronounce
correctly *(Amicus)*. I am also a Fellow of the
American College of Trust & Estate Counsel,
Chair of its Arbitration Task Force,
and Chair of its Fiduciary Litigation Committee.
To these they applaud loud and proud
and without their smart little quips,
For they know these groups take them
on wonderful trips.

They could care less that I frequently lecture
for the Florida and New York Bars on probate
and trust topics, including fees, fiduciary duties,
will and trust contests
Or that I teach a course each summer on fiduciary
duties for trust officers and graduate-trust officers
at the Florida Bankers Association's Trust School
Or that I've authored several CLE publications
including: *The Dead Man's Statute*, *Tortious
Interference with a Devise,* and
Federal Jurisdiction over Probate Matters.
Or even that I'm listed in
The Best Lawyers in America.

For them it is what I've done to make them laugh lately
And whether I've taken the time to be Daddy.

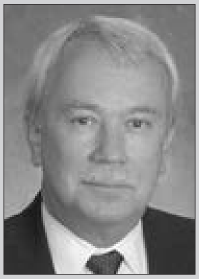
Duncan Osborne *(International Estate Planning Committee)* is the senior partner of Osborne, Helman, Knebel & Deleery, L.L.P. He graduated from University of Texas Law School (J.D., with honors, 1971). His core practice is estate planning with a significant emphasis on asset protection planning, particularly in the international arena. A former adjunct professor of law at the University of Texas School of Law, Duncan devotes significant energy to lecturing and writing, both domestically and internationally, on the subject of offshore trust and asset protection planning. Duncan is the original editor and a contributing author of the four-volume treatise, *Asset Protection: Domestic and International Law and Tactics,* published by Clark Boardman Callaghan in 1995 (updated Quarterly). Duncan is an Academician in the International Academy of Trust and Estate Law (IAETL).

Susan T. House *(Membership Selection Committee)* is a partner in the Pasadena law firm of Hahn & Hahn, LLP, where she has practiced for more than 30 years. Founded in 1899, Hahn & Hahn has 23 lawyers. Susan is a co-author (with ACTEC Fellow William S. Johnstone, Jr.) of *California Conservatorships and Guardianships* and is a co-editor (with ACTEC Fellow Bruce S. Ross) of *Guide to the California Rules of Professional Conduct for Estate Planning,* Trusts and Estates Section of the State Bar of California (1997). Susan is a past Chair of the Executive Committee of the Trusts & Estates Section and past Regent of ACTEC. She is a frequent lecturer for CEB, the University of Southern California, UCLA, ALI-ABA and various bar associations. Susan's husband, Jim, is a retired physician currently doing research at Caltech in Pasadena. They have one daughter, Allison, who is 17 years old.

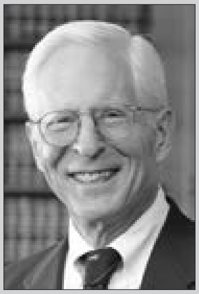


Robert J. Rosepink *(Nominating Committee)* is a member of Rosepink & Estes, P.L.L.C., located in Scottsdale, AZ. The firm's practice is limited to estate planning, probate, and trust law. Bob is a Special Consultant to Tax Management, serving as reviser of 865 T.M., *Charitable Remainder Trusts*. He is a member of the ABA and its Sections of Taxation and Real Property, Probate and Trust Law. A past President of ACTEC, Bob is a Fellow of the American College of Tax Counsel and an Academician in the International Academy of Estate and Trust Law. Bob and his wife, Susan, have two children: Adam, 24, and Christopher, 21.

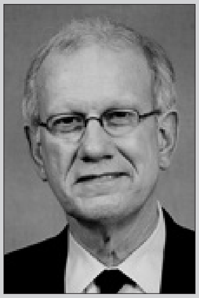
Hugh Kendall *(Professional Responsibility Committee)* is a sole practitioner in Chattanooga, TN, and presently practices in association with ACTEC Fellow Randy Van Dolson under the name Kendall Van Dolson. Having previously passed through the chairs of all the usual state and local committees and councils relating to trust and estate law, when he is not working on ACTEC Professional Responsibility Committee matters, Hugh now spends the bulk of his non-billable office time as a member of the Committee on Ethics and Professional Responsibility of the Tennessee Bar Association. Hugh and his wife, Kay Marie, have two sons. Jonathan is an engineer and director of Channel Communications with The Lowes Companies, and David is a corporate loan analyst with First Tennessee Bank in Knoxville.



W. Bjarne Johnson *(Program Committee)* is a shareholder in the law firm of Church, Harris, Johnson & Williams, P.C., with offices in Great Falls and Missoula, MT. In addition to serving on the University of Montana School of Law Tax Institute Advisory Board, Bjarne often lectures on computer-assisted practice leverage opportunities for lawyers. He remains involved in the continued development of the College's website and related electronic resources available to the Fellows. Bjarne's wife Dena, also an attorney, is a computer consultant who provides document automation and legal practice systems programming and consulting services to law firms nationwide. Bjarne and Dena have one daughter, Jenny, age 13.



Hanson S. Reynolds *(Sponsorship Advisory Committee)* is a partner in the Boston law firm of Rackemann, Sawyer & Brewster, where he focuses his practice on fiduciary litigation, including service as an expert witness and consultant. The firm has 44 lawyers; 11 are active in the trust and estate area. A past President of ACTEC, Hanson is a former Director of The Boston Foundation, the sixth largest community foundation in the country, and he was Chair of its investment committee for five years. Hanson's family includes his long-time partner, Sharon Gray, four children, two grandsons, and a granddaughter—all of whom share his enthusiasm for hiking and fishing.



James K. Treadwell *(Technology in the Practice Committee)* is a shareholder with the 40-lawyer Seattle law firm of Karr Tuttle Campbell. He has been with this firm since 1988. In addition to his involvement with ACTEC, Jim continues to be involved with state bar association committee activities, with various non-profit organizations, including the Washington Planned Giving Council, and with the alumni board of his law school alma mater, the University of Oregon. Jim and his wife of 39 years, Shari, live in Seattle. They have two sons: Bradley, who is a regional representative of Kavo International, a large manufacturer of dental equipment; and Spencer, who represents AMNET, a wholesale mortgage arm of Wachovia. Both are happily married and live in Seattle. The birth of Jim and Shari's first grandchild will coincide with this year's summer meeting in Los Angeles.

Committee Appointments 2007-2008

by Daniel H. Markstein, III

Birmingham, Alabama

Perhaps my most important responsibility as President-Elect is to appoint and reappoint members of the College's committees for the next College year, 2007–2008. These appointments will be effective at the end of the 2007 Annual Meeting in Scottsdale, Arizona, through the 2008 Annual Meeting in Boca Raton, Florida. The first step in the process is to determine who is interested in committee membership and on which committee or committees you would like to serve.

If you would like to serve on a committee for the coming year, whether it is a committee that you have served on before or one that is new for you, I must hear from you **no later than October 23, 2006.** If you fail to inform me of your interest, I will not be able to appoint you. If you do let me know, I will do my best to accommodate your preferences.

If you are interested in committee membership, please log on to the private side of the ACTEC website and submit the online committee appointment form (contact Bill Crawford at wlcrawford@actec.org if you need a user name and password), or complete and submit the committee appointment request form that accompanies this issue of the *ACTEC Journal*. If you are requesting an appointment to a committee on which you have not served, please let me know of any special experience that you have that may be helpful to that committee's work. Send the completed form before October 23, 2006 to:

Gerry A. Vogt, Executive Director
The American College of Trust and Estate Counsel
3415 South Sepulveda Blvd., Suite 330
Los Angeles, California 90034
Fax: (310) 572-7280

Most committees meet three times each year in conjunction with each of the College's national meetings. For 2007-2008, these meetings will take place in the summer in Salt Lake City, Utah, in the fall at The Greenbrier in White Sulphur Springs, West Virginia, and in the spring in Boca Raton, Florida.

The College reimburses committee members' expenses at the fall and summer meetings (but not at the annual meeting) up to a maximum of $250 for each meeting. Academic Fellows are entitled to a reimbursement of $600 for all three meetings.

We expect committee members to attend committee meetings and actively to participate in committee work. Contributions to committee work and attendance will be considered in evaluating reappointment requests. To that end, I will ask each committee chair for an evaluation of each committee member's participation and for a recommendation regarding reappointment.

I hope that each of you will seriously consider committee participation. The College's committees play a vital role in the life of the College and add importantly to the College experience of those Fellows who take part. They provide fora for discussion, facilitate the preparation of reports and articles on topics of interest to Fellows, help produce the College's educational programs, and often initiate the process that leads to the College's filing *amicus* briefs or filing technical comments with the Internal Revenue Service.

ACTEC COMMITTEES

Listed below are the committees to which I will appoint members, together with the name of the current committee chair, the number of members, and a brief description of the committee's purpose and activities. The current number of members of each committee may be maintained, increased or reduced.

Business Planning Committee (98)
Nancy Schmidt Roush, Chair

The Business Planning Committee considers planning approaches and techniques under present law with emphasis on income and transfer tax considerations faced by taxpayers whose major assets are interests in operating businesses. Valuation, succession planning and liquidity are topics that the committee has under review.

Bylaws and Manual Committee (5)
Glen A. Yale, Chair

The Bylaws and Manual Committee updates the bylaws and manual. The bylaws and manual are living documents and require constant adjustment.

Charitable Planning and Exempt Organizations Committee (91)
Howard M. McCue, III, Chair

The Charitable Planning and Exempt Organizations Committee considers all aspects of charitable planning, charitable giving and exempt organizations.

Editorial Board (18)
Joseph J. Hanna, Jr., Chair

The Editorial Board has responsibility for all publications of the College, including the *ACTEC Journal* and the *ACTEC Studies*, the Membership Roster, and additional materials that are published by the College from time to time, such as the annual *Pocket Tax Tables*. A primary responsibility of the Editorial Board is to identify and recruit authors to write and update articles of interest to the Fellows.

Elder Law Committee (38)
Robert M. St. John, Chair

The Elder Law Committee reviews, discusses and comments on guardianship legislation and procedure, health law, legal alternatives to guardianship, elder abuse issues, elder law insurance issues, long term care issues, government entitlements, conservatorships and end-of-life issues, and books and professional literature on elder law topics.

Employee Benefits in Estate Planning Committee (42)
Natalie B. Choate, Chair

The Employee Benefits in Estate Planning Committee considers developments in the employee benefits area, with a special emphasis on the ever-changing tax implications.

Estate and Gift Tax Committee (90)
Dennis I. Belcher, Chair

The Estate and Gift Tax Committee monitors tax developments in the transfer tax area and has been active in responding to Treasury and congressional proposals and the filing of *amicus* briefs.

Fiduciary Income Tax Committee (41)
Barbara A. Sloan, Chair

The Fiduciary Income Tax Committee reviews the latest developments relating to fiduciary income taxes and considers proposals for reform.

Fiduciary Litigation Committee (101)
Robert W. Goldman, Chair

The Fiduciary Litigation Committee focuses on will and trust contests, fiduciary responsibility issues, attorneys' and fiduciaries' compensation disputes, evidentiary issues in estate and trust litigation, alternative dispute resolution and liaison with judges, construction, instruction and reformation and malpractice issues. The committee also sponsors the biennial Sam Smith Memorial Lecture at the ACTEC fall meeting, featuring nationally known speakers on estate and trust litigation topics.

International Estate Planning Committee (45)
Duncan Elliott Osborne, Chair

The International Estate Planning Committee focuses on the planning issues that face individuals who have (or plan to have) multinational assets and/or multinational families. These issues include taxation, probate and succession and asset protection.

Legal Education Committee (39)
Kevin D. Millard and
Anne-Marie Rhodes, Co-Chairs

The Legal Eduction Committee focuses on the quality and relevance of the content of trust and estate courses offered in law schools across the country and the role of adjunct professors.

Practice Committee (54)
William C. Weinsheimer, Chair

The Practice Committee considers the ways and means that trust and estate lawyers can expand their practices by adding other areas of expertise, how they can increase the efficiency of their practices through new methods and technologies and the manner in which Fellows should deal with practical and ethical problems in their existing areas of practice.

Professional Responsibility Committee (42)
Hugh F. Kendall, Chair

The Professional Responsibility Committee considers ethical issues faced by Fellows in the practice of trust and estate law. Having finalized for publication the Fourth Edition of the *ACTEC Commentaries on the Model Rules of Professional Conduct*, which provides advisory guidelines for practitioners of trust and estate law, the committee is now updating the companion *Engagement Letters* project. The committee will continue to study developing ethical issues for the College.

State Laws Committee (57)
Marguerite L. Adams, Chair

The State Laws Committee works on topics regulated at the state level, such as state death tax legislation (especially in the wake of the 2001 federal legislation), the prudent investor rule, curative tax statutes, standby guardianship legislation, uniform laws, notice in probate, apportionment of federal estate taxes, environmental issues, rights of creditors and fiduciary accounting.

Technology in the Practice Committee (37)
James K. Treadwell, Chair

The Technology in the Practice Committee provides information to the Fellows on computer hardware and software for estate planning and administration and has been actively involved in maintaining the College's website.

Transfer Tax Study Committee (16)
Joseph M. Dodge, Chair

The Transfer Tax Study Committee studies and reports on changes in the transfer tax law that would improve the tax system.

COMMITTEE MATERIALS

If you would like to view the agendas, minutes and written materials of the committees, you may do so on the private side of the ACTEC website. Navigating the site is easy, for all you need is a user name and password, which you may obtain by contacting Bill Crawford at wlcrawford@actec.org. Once you have logged in, go to the Meetings box on the right side of the page, and there you will find a link to the committee agendas, minutes and handouts for the most recent national meeting, as well as a link to the committee archives. Thank you for your interest and participation in the work of the College.

include this power, but the consistency requirement would depend upon the way the power to adjust statute was written and applied. If the allocation of capital gains did not affect the amount of the distribution, such as in a unitrust, then it is likely that the power to adjust would bring with it the same consistency requirement imposed upon the unitrust. So the overall rule would be that if the allocation of capital gains to income did not determine the amount that was paid out, then it was really just a tax accounting practice that must be applied consistently. If under the terms of the statute, the adjustment of principal to income were dependent upon the realization of capital gains during the tax year, then the power would only have to be exercised reasonably and impartially, not consistently.

The express change in the Regulation language eliminating the word "consistently" argues strongly that the power to adjust would allow one to change capital gain treatment in DNI from time to time. The reason for the change as expressed in the Summary, however, reflects a likely misunderstanding of the power to adjust and argues strongly that consistency should be required.

Since neither the Uniform Act nor any state statute adaptation of the power to adjust ties the adjustment to realized capital gains, the author concludes on the basis of tax policy that for a trustee to have the power to include capital gains in DNI as part of the power to adjust, the trustee would have to make that decision on a consistent basis. Further guidance is definitely needed.

So the existence of the power to consider capital gains as part of an adjustment from principal to income is quite uncertain, as is the consistency requirement if the power exists. This is more confusing than it is critical, since the adjustment can simply take into account the tax effects, as noted in the Uniform Act. If a trustee were to not include capital gains in DNI, then the trustee could have relative certainty, since if the trustee had the power to include the capital gains in income, then by filing without doing so, the trustee would have exercised that power, which it is likely (but not certain) to be required consistently in the future. If the trustee did not have that power, then capital gain should be taxed to the trust, as that is the default rule. It is difficult to see a scenario in which the trustee can include capital gain in DNI and have certainty, unless the governing document grants the trustee the express power to do so, which is unlikely at the present time, unless a general power to make tax elections were considered to be sufficient, which is subject to some considerable doubt if proof of that power is required to be quite specific.[135] If one looks at a trustee's power as residual in nature—that is, the trustee has all appropriate powers to deal with trust property except those which are denied to it, then a trustee's power to allocate capital gains to DNI will probably be present in the majority of trusts in the majority of states, since most state laws and most governing instruments are silent on the subject. This silence is unfortunate, since taxing out the capital gains to the beneficiary will generally be desirable, though improvement in regulatory guidance would be preferable to further importation of tax concepts into our principal and income laws.

Going forward, it is quite important to include such a power in our state statutes so that the issue is not left to doubt, and in our documents to the extent that it is not in our state statutes.

Further guidance by the Service as to whether a specific power must be included by state statute or by governing instrument, or whether in the absence of a prohibition the power will be presumed would be very helpful. Capital gain is, after all, a tax concept and has not typically been included as a concept in either trust law or trust instruments.

5. Generation-Skipping Transfer Tax— the concerns of those fearing the loss of generation skipping transfer tax grandfathering were quelled by the Final Regulations:

> (D) * * *
> (2) * * * In addition, administration of a trust in conformance with applicable local law that defines the term income as a unitrust amount (or permits a right to income to be satisfied by such an amount) or that permits the trustee to adjust between principal and income to fulfill the trustee's duty of impartiality between income and principal beneficiaries will not be considered to shift a beneficial interest in the trust, if applicable local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and meets the requirements of §1.643(b)-1 of this chapter.
>
> <u>Example 11</u>. <u>Conversion of income interest to unitrust interest under state statute</u>. In 1980, Grantor, a resident of State X, established an irrevocable trust for the benefit of Grantor's child, A, and A's issue. The trust provides that trust income is payable to A for life and upon A's death the remainder is to pass to A's issue, *per stirpes*. In

[135] *See* Sloan, *supra* n. 93, at 39.

2002, State X amends its income and principal statute to define income as a unitrust amount of 4% of the fair market value of the trust assets valued annually. For a trust established prior to 2002, the statute provides that the new definition of income will apply only if all the beneficiaries who have an interest in the trust consent to the change within two years after the effective date of the statute. The statute provides specific procedures to establish the consent of the beneficiaries. A and A's issue consent to the change in the definition of income within the time period, and in accordance with the procedures, prescribed by the state statute. The administration of the trust, in accordance with the state statute defining income to be a 4% unitrust amount, will not be considered to shift any beneficial interest in the trust. Therefore, the trust will not be subject to the provisions of chapter 13 of the Internal Revenue Code. Further, under these facts, no trust beneficiary will be treated as having made a gift for federal gift tax purposes, and neither the trust nor any trust beneficiary will be treated as having made a taxable exchange for federal income tax purposes. Similarly, the conclusions in this example would be the same if the beneficiaries' consent was not required, or, if the change in administration of the trust occurred because the situs of the trust was changed to State X from a state whose statute does not define income as a unitrust amount or if the situs was changed to such a state from State X.

<u>Example 12</u>. <u>Equitable adjustments under state statute</u>. The facts are the same as in <u>Example 11</u>, except that in 2002, State X amends its income and principal statute to permit the trustee to make adjustments between income and principal when the trustee invests and manages the trust assets under the state's prudent investor standard, the trust describes the amount that shall or must be distributed to a beneficiary by referring to the trust's income, and the trustee after applying the state statutory rules regarding allocation of receipts between income and principal is unable to administer the trust impartially. The provision permitting the trustees to make these adjustments is effective in 2002 for trusts created at any time. The trustee invests and manages the trust assets under the state's prudent investor standard, and pursuant to authorization in the state statute, the trustee allocates receipts between the income and principal accounts in a manner to ensure the impartial administration of the trust. The administration of the trust in accordance with the state statute will not be considered to shift any beneficial interest in the trust. Therefore, the trust will not be subject to the provisions of chapter 13 of the Internal Revenue Code. Further, under these facts, no trust beneficiary will be treated as having made a gift for federal gift tax purposes, and neither the trust nor any trust beneficiary will be treated as having made a taxable exchange for federal income tax purposes. Similarly, the conclusions in this example would be the same if the change in administration of the trust occurred because the situs of the trust was changed to State X from a state whose statute does not authorize the trustee to make adjustments between income and principal or if the situs was changed to such a state from State X.[136]

From these two new examples, we get even more than what we might have expected. Not only did Treasury bless the conversion to a unitrust and the use of the power to adjust under applicable local law as not causing a loss of grandfathering for GST purposes, but such a change in definition of income under state law is not a gift or a sale or exchange.

And even better, Examples 11 and 12 very clearly give Treasury's blessing to a change in situs from a state without total return legislation to one with total return legislation. In such case the conclusions would be the same as if the trust had stayed in a state where the law had changed. A change in situs will not automatically bring with it a change in state law concerning income and principal, as, for example, where the trust instrument contains a choice of law pro-

[136] Treas. Reg. §26.2601-1(4)(i)(D)(2).

vision as to administration of the trust even if the situs has changed,[137] but in the absence of such a provision it is likely that the administration of the trust will be governed by the state of administration.[138] While the determination of governing law could otherwise be a bit thorny, it is likely that such changes in situs will occur primarily when there is consensus among all of the parties, which as a practical matter is likely to smooth the process, particularly if the Service does not have a bone to pick concerning the change of situs to obtain more favorable administrative provisions.

So a trust in Rhode Island or North Dakota, which do not have a favorable total return trust law as of yet, might be moved next door to South Dakota, which has unitrust legislation, or Connecticut, which has the power to adjust, or Delaware or Nebraska, which have both, and take advantage of those more modern laws. The laws and process of changing situs of a trust depend upon state law as well and, of course, the terms of the governing instrument, so every trust may not be able to do this successfully, but this should significantly increase the pressure on states which do not have total return legislation to put it on their agenda or suffer the financial consequences to their financial services and trust businesses.

6. Marital Deduction is Safe. The new definition of income under Section 643(b) is specifically incorporated into the power of appointment marital trust under 20.2056(b)-5.

> (f) * * * (1) * * * In addition, the surviving spouse's interest shall meet the condition set forth in paragraph (a)(1) of this section if the spouse is entitled to income as determined by applicable local law that provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and that meets the requirements of §1.643(b)-1 of this chapter.

And the QTIP trust provisions were amended under §20.2056(b)-7:

> A power under applicable local law that permits the trustee to adjust between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries that meets the requirements of §1.643(b)-1 of this chapter will not be considered a power to appoint trust property to a person other than the surviving spouse.

At first glance one might conclude that the power to convert to a unitrust would not be acceptable for a QTIP trust, since only the power to adjust is specifically mentioned in that section, but the preexisting Regulation §20.2056(b)-7(d)(2) states that the principles of 20.2056(b)-5(f) relating to the spouse's income interest apply to a (b)-7 QTIP interest as well, thus incorporating the general power of appointment "fix" quoted above for the QTIP trust as well as to the definition of income. While the power to convert to a unitrust could have been included in the language of the (b)-7 regulation specifically, it was probably not thought to be necessary, once the change was made so that "income" was deemed equivalent for marital deduction purposes, particularly since with the unitrust, there is no continuing power other than the power to switch back and forth under applicable local law, and Treasury was comfortable with that.

7. Distribution in Kind to Satisfy New "Income."

Confirming the provisions in the Proposed Regulations, a distribution of an asset in kind in satisfaction of income under a unitrust statute or the power to adjust will be a realization event for a simple trust under Treas. Reg. §1.651(a)-2(d) and for a complex trust under Treas. Reg. §1.661(a)-2(f), and a distribution of more than the ordinary income in this context will not disqualify the trust as a simple trust. *See* Treas. Reg. §1.651(a)-2(d).

8. Charitable Remainder Unitrusts-NICRUTs and NIMCRUTS.

In its plain vanilla format, the new definitions of "income" should have no effect on the charitable remainder unitrust, which already defines what is distributed based upon a unitrust payout. And both the Uniform Act and most state statutes exclude from the operation of the power to adjust or the power to convert to a unitrust a trust which describes what is payable to the beneficiary as a fixed annuity or a fixed fraction of the value of the trust assets[139] But in a net income CRUT, the lesser of the net income or the unitrust amount is paid out, and in the net income with makeup CRUT, or NIMCRUT, if the income is greater than the unitrust amount, the income may be paid out until the amount paid in excess of the unitrust amount

[137] *See* Sloan *supra* n. 93, at 30.
[138] *See* Blattmachr and Gans, *supra* n. 93, at 914.
[139] Unif. Principal and Income Act, *supra* n. 11, §104(c)(3).

makes up for any previous shortfalls below the unitrust amount. In these two CRUT variations, then, the net income does matter, and the new state law income definitions and the Final Regulations fit together rather imperfectly. The Regulations do not allow income to be defined as a unitrust amount in the context of a NICRUT or a NIMCRUT, since to do so would basically allow a payout of less than 5%.[140]

The NICRUT or NIMCRUT trust provisions may direct that post contribution realized gain may be allocated to income if not prohibited by applicable local law, and a discretionary power to make this allocation can be given to the trustee, but only to the extent that the discretionary power is given to the trustee to treat the beneficiaries impartially.[141] It is possible that this will be a useful power, but because the power given in the Uniform Act does not limit the adjustment to post contribution gains, it is not likely to be available unless amendments are made to fit within the Regulation. Indeed, the Uniform Act should preclude the exercise of the power to adjust because of the provision contained in Section 104(c)(4)that an adjustment must not be made

> (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.[142]

Literally, the charitable remainder unitrust is a trust for which the portion not distributed is set aside for charitable purposes. The phrasing of the exclusion is identical to that used in Section 642(c), however, so that in states following the language in the Uniform Act, it may not be entirely clear that the power to adjust or a power to convert to a unitrust is entirely precluded for a NICRUT or NIMCRUT, if this limitation applies only to those trusts relying upon the Section 642(c) set aside deduction, since the NICRUT and NIMCRUT rely upon Section 664 for their exemption from tax, rather than the 642(c) deduction to escape taxation for capital gains incurred.[143] Unfortunately also, the Comments do not provide any helpful insight, as there is no comment concerning the (c)(4) exclusion, and a comment limiting the (c)(3) exemption (the power to adjust is not applicable to a trust that pays out an annuity or unitrust amount) could infer that it does apply:

> For example, if a beneficiary is to receive a fixed annuity or the trust's income, whichever is greater, subsection (c)(3) does not prevent a trustee from making an adjustment under Section 104(a) in determining the amount of the trust's income.

This is an argument outside the literal wording of the Uniform Act, and so in this author's opinion, the power to adjust should be precluded for a NICRUT or NIMCRUT. This is helpful, in that otherwise the Regulation could cause disqualification of the trust, clearly not an intended result. Some other states, such as Pennsylvania, added language to preclude the application of the power to adjust and the power to convert to a unitrust only where a gift or estate tax deduction has been taken.[144] Since a gift or estate tax deduction will always have been taken for a NICRUT or NIMCRUT (though not a deduction under Section 642(c)), this should be sufficient to preclude the application of the power to adjust or the power to convert to a unitrust.

Going forward, drafters should take this Regulation into account, and it may be helpful to add language to legislation applicable to the NICRUT and NIMCRUT that fits within the Regulation's requirements, clearly precluding a unitrust conversion in all cases and permitting adjustments only from post contribution gains, and then only as required to satisfy the duty of impartiality. In the meantime, it is unlikely that there will be any way to use the power to adjust or the power to convert to a unitrust with these trusts—the best result being simply that these powers are inapplicable. If there are concerns under applicable state law about whether the power to adjust or the power to convert to a unitrust might apply, a release of the power to adjust under Section 104(e) or a release of the power to convert might be advisable to insure that qualification under Section 664 is not threatened.

9. The Pooled Income Fund.

The Final Regulations do allow for state law changes in conformance with 1.643(b)-1, so that a trust can still be considered to be a pooled income fund even if state law would give the trustee the power to convert to a unitrust, though for the power to adjust, the trustee may not allocate to income

[140] Treas. Reg. §1.664(3)(i)(a)(1)(b)(3). Just as an aside, this makes only marginal practical sense, since the deduction granted for the NICRUT assumes actuarially that the 5% is paid out. Why prohibit a taxpayer from paying herself less and thereby giving the charity more later?

[141] *Id.*

[142] Unif. Principal and Income Act, *supra* n. 11, §104(c)(4).

[143] *See* Blattmachr and Gans, *supra* n. 93, fn. 61.

[144] *See* 20 Pa.C.S. §§8104(c)(4), 8105(i)(2).

the portion of proceeds of an asset representing the value of the asset when contributed to the trust or when purchased in the trust.[145] However, for the same reason set forth with reference to the NICRUT and NIMCRUT, it seems that the Section 104(c)(4) should preclude the application of the power to adjust, since the income and principal are not both set aside for charitable purposes.

However, while the foregoing application of the definition of income as a unitrust amount and the limited use of the power to adjust do not disqualify the pooled income trust as a pooled income trust, the possibility of paying out a unitrust amount or the adjustment of principal to income which takes into account unrealized appreciation does disqualify the capital gains realized in the pooled income trust from the set aside deduction given by 642(c).[146] The income in a pooled income fund is not exempt from taxation, since it is distributed to the non-charitable beneficiary of the trust, but capital gains realized are held in the fund and not distributed, and hence enjoy the permanent set aside deduction, but if a unitrust definition of income is used, then obviously the realized capital gains may be used to satisfy a portion of the unitrust amount, and as such, the charitable set aside deduction is denied. So also with the power to adjust if it may take into account unrealized appreciation in the fund (which it may). This effect is prospective, however, and it could be avoided by reformation:

> In a state whose statute permits income to be determined by reference to a fixed percentage of, or the unrealized appreciation in, the value of the fund's assets, net long-term capital gain of a pooled income fund may be considered to be permanently set aside for charitable purposes if the fund's governing instrument is amended or reformed to eliminate the possibility of determining income in such a manner and if income has not been determined in this manner. For this purpose, a judicial proceeding to reform the fund's governing instrument must be commenced, or a non-judicial reformation that is valid under state law must be completed, by the date that is nine months after the later of January 2, 2004 or the effective date of the state statute authorizing determination of income in such a manner.[147]

It is the author's opinion that this reformation should have been needed in very few instances, because the language of the Uniform Act provides a savings provision that causes the power to adjust not to be applied to charitable split interest trusts. In addition, even if it were held to apply, the trustee could permanently release the power to adjust principal to income under Section 104(e). Whether this release would be considered a "non-judicial reformation" is not entirely clear, but it should be considered as sufficient.

At this time, such a reformation will only be an issue for new statutes, as otherwise the window of opportunity has closed. But even if that window is still open, it is submitted that the trustee should consider carefully whether the power to adjust or the power to convert to a unitrust should be eliminated, since without these powers, the trustee may well not be able to invest for total return, and the ability to invest for total return is likely more valuable than the charitable deduction on capital gains!

For example, the ability to invest for total return may allow the trustee to invest in 80% equities and 20% fixed income, while without such power the trustee might invest in 50% equities and 50% fixed income. Assume that the equities in both portfolios are highly appreciated (80% capital gain) and that the portfolio is actively managed with a 25% turnover ratio. Even in that situation, the average ending market value for a 4% unitrust payout over all of the rolling 20-year periods in history would be significantly greater than having the more conservative asset allocation and never paying out any principal or capital gains. In the foregoing example, the average ending market value for the 4% unitrust enabled to invest for total return is over 43% more than the average ending market value of the more conservatively invested and distributed trust.

In summary, judicial reformations are probably unneeded because of the protective language already in most state statutes, but if they were needed, they may well be inadvisable, as the reformation would be giving up something (the ability to invest for total return) which is clearly more valuable than what was gained-that is a 0% tax on capital gains inside the pooled income fund. For the foregoing calculations, it was assumed that the capital gains distributed to the taxable beneficiary can be taxed out to her

---

[145] *See* Treas. Reg. §1.642(c)(5).

[146] *See* Treas. Reg. §1.642(c)(2).

[147] *See* Treas. Reg. §1.642(c)(2)(e).

as part of DNI, which should be possible if done on a consistent basis.

10. What Other Acronyms are Affected—QSSTs and QDOTS.

While not mentioned in the Final Regulations, the summary makes clear that the new regulations and the new state law definitions of income apply to Qualifying Subchapter S Trusts because the 643(b) definition of income is incorporated through Section 1361(d)(3). This may be particularly important with the power to adjust, which can flexibly respond to situations involving a closely held company held in a trust.

The QDOT regulation was changed to specifically allow the new state law definitions of income under 26.2056A-5(c)(2) which should be particularly helpful in the context of the Qualified Domestic Trust because of the imposition of the federal estate tax on the payment of any principal during the life of the surviving non-citizen spouse. Discretionary powers to distribute principal in such a trust could not sensibly be utilized, so that a unitrust definition of income or the power to adjust would be particularly helpful in this context, wherein there is no practical alternative to modernizing our notion of income.

D. DESIRABLE LEGISLATIVE RESPONSES TO THE REGULATIONS

1. Regulations Likely to Spark an Additional Round of Legislation.

What the Regulations make crystal clear is that those states without modern total return statutes are and will continue to be at a disadvantage compared to those states which have taken the plunge towards the future.

For existing trusts, trustees will continue to be trapped in many cases in an "income" regime that does not allow them to invest for total return and puts them in the middle as between the current income beneficiary and the remainder beneficiary. Without a unitrust conversion statute, even if the trustee could convince a local court that it had the power to reform the income trust into a unitrust, there would be all of the questions surrounding the conversion that practitioners were worried about before the Regulations were made final. While PLR 200448001 is encouraging, it seems quite clear that where there is such a conversion, the trustee and her attorney are not safe in assuming that the generation skipping transfer tax grandfathered status has been preserved, that the marital deduction is safe or even that the income interest may not have been "sold" in the process.[148] And if a conversion occurs in a state with neither a unitrust conversion statute nor the power to adjust, there is no safety at all from these tax issues.

For new trusts, the drafter in a non-unitrust state will continue to be required to draft their unitrusts which are intended to qualify for the marital deduction as requiring the unitrust amount or the net income, whichever is greater. And there may well come a time in the world of investments when very high interest rates make that a real problem. And a QDOT simply cannot be drafted as a unitrust without a unitrust statute. It simply cannot be done in a state without a unitrust definition of income. So Texas practitioners, despite the absence of a unitrust conversion statute, should be in good shape for drafting unitrusts for marital trusts and QDOTs, because it has adopted an alternative unitrust definition of income, while practitioners in the 22 states which have only the power to adjust probably cannot safely draft QDOTs as unitrusts, or for that matter, the even more frequently useful QTIP trust, without requiring that the net income be paid out if greater than the unitrust amount. Ohio's virtually airtight unitrust safe harbor might provide a strong argument that a trust drafted as a 4% unitrust is paying out all of the "income" under Ohio law, but a ruling of some sort would be needed to give any level of assurance.

Worse yet for those states which have not taken the plunge is the fact that Treasury has given a very clear green light to changing the situs of trusts from a state without total return legislation to one that has such legislation. That is very likely to produce significant competitive pressure on those without the necessary statutory support to add that support, and to add it soon, so as not to disadvantage its banks, trust companies and other trust professionals.

Just as the Proposed Regulations resulted in a spurt in legislation across the country, so the Final Regulations should also be a catalyst for change to motivate the states which have not been quick to act.

2. States With Total Return Legislation Should Consider a Tax Regulation TRU-up!

States which have enacted total return legislation should promptly consider whether additional changes or fine tuning are necessary in light of the issuance of the Final Regulations. Because of the variety of the legislation, it is difficult to generalize as to

[148] Even if court approval were obtained, a private letter ruling would be needed to see whether the "stealth" ruling discussed previously, is solid or an aberration. The fact that the underlying facts of that ruling was a conversion to a regime paying out the income or the unitrust interest, whichever is greater, makes the ruling weak authority on the marital deduction and GST grandfathering issue, which would have been satisfied under those facts prior to the Final Regulations.

what might be needed, but several general points might be considered.

First, a number of states required that unitrust conversions of marital trusts and trusts which are grandfathered from generation-skipping transfer tax to include a pay out of the income or the unitrust amount, whichever is greater. This is no longer necessary, and is therefore an unfavorable provision to retain in the law, since it could force distributions to be too large and produce conflicts in making investment decisions in a future period of high interest rates.

Second, but probably more important, in the author's opinion, is that essentially none of the legislation deals adequately with the trust that is drafted as a unitrust. It is very important that states consider adding provisions aimed at this increasingly common situation. The Final Regulations give an imprimatur to methods of defining income which reasonably apportion the annual total return from a trust and which are "pursuant" to a state statute. The concern is that the drafting of a unitrust as a unitrust may be "consistent with," but not "pursuant to" a state statute. This may be an overly technical reading of the Final Regulations but the Regulations have taken pains in the definition of income 1.643(b)-1 to use the word "statute" rather than the prior reference to "applicable local law," the latter reference being the words used in Code Section 643(b) itself. While it is the author's opinion that the Service will, for example, accept a 4% unitrust for the marital deduction in a state with a unitrust conversion statute with a default rate of 4%, and a Treasury representative has orally indicated her agreement with this, it will be a great deal more comfortable to point to a state statute that discusses express unitrusts as such, so that there can be no doubt that the trust drafted as a unitrust is "pursuant" to a state statute. A second reason for revisiting these statutes is to consider whether the provisions that are appropriate for a trust which is converted are the same as the provisions which are appropriate for those trusts drafted as a unitrust. Quite a few states[149] have a default rate of 4% for their converted unitrusts with no reference to the 3-5% range allowed by the Final Regulations. These states may wish to add, where necessary, a statutory recognition of that range for trusts expressly drafted as unitrusts, to eliminate any question about whether the applicable state law requirement is met for those trusts. In the meantime, for example, a marital trust drafted in Pennsylvania must have a payout rate of at least 4% to be a safe bet to qualify for the marital deduction, and this may not be desirable in quite a few cases, particularly if the marital trust may be exempt from GST taxes and be intended to go on for multiple generations. And even that may not be really safe because a 4% unitrust is parallel and consistent with the Pennsylvania unitrust statute. It is not "pursuant" to it.

Third, in order for trustees to have better assurance that they know what their options are with respect to including capital gains in DNI, state laws need to address that area for unitrusts and for the power to adjust at a minimum, and in the opinion of this author and other commentators, ought to insert additional language giving the trustee discretion over this capital gain issue wherever possible, such as for other discretionary distributions of "principal."

The issues to be addressed are governed by the present statutory framework on a state by state basis, but discussion based upon a general categorization will likely be helpful:

a. Power to Adjust Only States. For states with only the power to adjust and which have adopted the Uniform Act largely intact, there are a number of questions which might be considered.

Can the Tax Savings Provisions Be Withdrawn? The Uniform Act has a number of exclusions under Section 104(c) that were aimed at tax concerns and uncertainties existing at the time it was drafted.

> (c) 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 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;
>
> * * *
>
> (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;

[149] Alaska, Georgia, Maine, Maryland, New York, Oregon, Pennsylvania, and Washington. New Hampshire is similar but uses a 5% rate.

(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.[150]

Should any of these tax protective provisions be withdrawn or revised at this time in light of the Final Regulations? There is nothing in the Final Regulations whatever that requires the power to adjust in the context of a marital deduction trust to never adjust the income downward. Indeed, it makes no sense for the power to adjust only to be the power to adjust upward, since the duty of impartiality runs uphill and downhill, depending upon the market conditions, yields and circumstances. It was never intended to be a one way street, as is noted in Example 2 to Section 104, which suggests that income should be transferred to principal under certain conditions. So should that provision be removed at this point?

And what of the other protective provisions, such as prohibiting an adjustment that reduces the actuarial value of an income interest where the gift tax exclusion is desired? The New York legislative advisory committee has suggested that this provision be deleted entirely, for reasons that seem well grounded, at least to this author.[151] First, it is entirely unclear that making an adjustment up or down to an income interest from time to time would have any effect on the actuarial value of the income interest. How does one determine the "actuarial value"? Is it the present value of all of the future cash flows? If so, what is the payout method, and what discount rate is used to determine the value?

The tables used by the IRS for valuation of an income interest assume that the 7520 rate is both the rate of return and the discount rate and that all of that return is distributed to the income beneficiary. That of course does not square with the "facts on the ground," The 7520 rate applicable for May of 2006 is 5.8%, and it is safe to say that most trustees hope to earn better than 5.8% on a total return basis in the long run. It is also safe to say that an income beneficiary would generally be thrilled to hear that she was getting a 5.8% payout. Further, if the trustee were to distribute all of the return to the income beneficiary, he would be violating the very principle of impartiality that the power to adjust was meant to address! Interestingly also, 5.8% is beyond the "safe harbor" 3-5% that Treasury has signaled loudly is an appropriate range, and yet their method of computing the value of income interests may well assume a range substantially above it, such as the 8% rate of June of 2000. It is difficult, therefore, to see how the power to adjust should influence this misvaluation. One is led to the following query:

> How can Treasury require that state laws defining income provide "a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year" as described in Regulation 1.643(b)-1, and then value the "income" interest on the basis that the entire total return from the trust is distributed to the income beneficiary?

And perhaps of more practical importance is the fact that if the exercise of the power to adjust did somehow influence the actuarial value of the income interest, the provision to exclude trusts intended to take advantage of the annual exclusion seems very much overbroad, since it could potentially include the host of life insurance or other trusts which rely on *Crummey* withdrawal powers to qualify gifts into trust for the gift tax annual exclusion. Of course, while these extremely common trusts do not need the Uniform Act exclusion, it would be unfortunate if the exclusion would serve to disable the trustees of those trusts from using the power to adjust, potentially for generations. For new trusts, the relatively less common trusts relying on an "income" interest for their qualification for the annual exclusion are probably ones in which other methods of qualification such as the *Crummey* withdrawal power are available or could

[150] Unif. Principal and Income Act, *supra* n. 11, §104(c).

[151] S 4548-B: TECHNICAL CORRECTIONS TO CH. 243, LAWS OF 2001.

be inserted. And in case of trusts for which transfers were made in the past, the gift tax annual exclusion has already been obtained, and hence could hardly be lost by virtue of later legislation. As a result, the New York Committee proposed eliminating this exclusion altogether.[152] Frankly, their arguments make good sense to this author.

As for the remainder of the listed exclusions, one is tempted to give due regard to the judgment of James Gamble, Co-Reporter for the Uniform Act, and conclude that it may be premature to withdraw these protective provisions. At the moment, they probably do no harm, and it is likely that changes to them should await further guidance from the Service. When the Regulations were written, Treasury had these provisions before them, so it is not clear what effect their withdrawal might produce. The one really important exclusion in the foregoing that will cause trouble sometime in the future is the one seeking to preserve the marital deduction. Here, perhaps a ruling from the Service would be quite helpful in giving guidance as to whether this exclusion is necessary. If it is necessary, it is likely to be interpreted as prohibiting an income to principal adjustment for trusts even if that were necessary in order to preserve impartiality and allow the trustee to invest for total return in a high inflation, high interest rate period. This provision is also overly broad in the opinion of this author, since unlike the exclusion concerning the annual exclusion for gift tax, it speaks to a trust for which the marital deduction "would be allowed." What about a credit shelter trust that pays the income to the surviving spouse? Certainly we have lots of them around, and there is no reason to deny them the power to adjust, unless we needed to correct some problems in the planning wherein a QTIP election were needed for that trust. This is too important a question to leave on the table, and a ruling on whether this exclusion could be withdrawn would be very helpful.

One other provision that it seems best to change in light of the Final Regulations is the one discussed previously that seems to cause some confusion in light of the Final Regulations:

> (1) 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;

As discussed previously, this provision is likely, but not certain, to protect the NICRUT and the NIMCRUT from problems with the Final Regulations in light of the fact that the provision tracks the 642(c) language, which does not apply to the trusts under Section 664. In addition, while it should protect the Pooled Income Fund from loss of the charitable deduction for realized long-term capital gains, it may also go too far in that it is not conditioned upon application to trusts for which such charitable tax benefits have been taken or qualified. For example, a trust which has a partially charitable remainder might be excluded from the benefits of the power to adjust simply because a portion of the trust proceeds will eventually go to charity. For this reason, Pennsylvania and some other states phrased the exclusion differently:

> (4) The adjustment is from any amount which is permanently set aside for charitable purposes under the governing instrument and for which a Federal estate or gift tax deduction has been taken unless both income and principal are so set aside.[153]

Whether this is ideal or not, it at least makes it clear that if the trust is one receiving no special charitable tax benefits, that the exclusion should not apply. The word "charitable" should probably be inserted before the word "deduction" to eliminate the possibility that a marital trust might be excluded, and the words "trust funds" might be better than the words "any amount" because in a NICRUT or NIMCRUT context the difference between the net income and the unitrust amount is not deductible, and it is preferable that the wording be as clear as possible that the exclusion does apply to such trusts.

The other change which should perhaps be considered in <u>all states</u>, including those with just the power to adjust would be a clear statutory basis for a trustee to consider capital gains to be part of distributable net income.

> Power to Treat Gains as Part of a Distribution of Principal.
>
> Unless prohibited by the governing instrument, the trustee of a trust shall have the power to consider gains from the sale of capital assets in the trust to be part of a distribution of principal to a beneficiary, [**In power to adjust states:** or part of an adjustment from

[152] Preliminary Draft Memorandum of the EPTL-SCPA Legislative Advisory Committee, a copy of which was kindly provided to the author.

[153] 20 Pa.C.S.§8104(c)(4).

principal to income], and if such power is exercised, such gains shall be treated consistently by the trustee on the trust's books, records and tax returns as part of a distribution to a beneficiary. [**Note that if one takes the position that the power need not be exercised consistently, different phraseology should be employed**].

It is, of course, not surprising that most states lack the express power to "deem" realized capital gains to be a part of a distribution of principal, since before the Proposed and Final Regulations, they would not have thought it helpful, or perhaps even possible, to have done so.

The foregoing provision should give trustees the power to exercise the new flexibility afforded by the Final Regulations, but which may well require explicit state law authority.

b. Delaware Style Unitrust States. Just as Delaware was the first state to adopt a unitrust conversion statute, it was also the first state to make significant changes to its statute to take into account the provisions of the Final Regulations.[154]

The changes made by Delaware represent a very good attempt to fine tune its statute to the new environment illuminated by the Final Regulations. It provides a worthwhile template for other states which have patterned their unitrust statute in whole or in part upon Delaware's statute.[155] They eliminated the unnecessary provisions concerning distribution of the income if greater than the unitrust amount for marital trusts and GST exempt trusts; they patched a gap in their notice provisions that clarify the persons entitled to receive notice; they expressly provide for the conversion of a wholly charitable trust to be converted to a unitrust under the statute also, and they added the following section to deal expressly with the unitrust that is drafted, rather than converted:

§3527A. Express total return unitrusts.

(a) The following provisions shall apply to a trust that, by its governing instrument, requires or permits the distribution, at least annually, of a unitrust amount equal to a fixed percentage of not less than three (3) nor more than five (5) percent per year of the fair market value of the trust's assets, valued at least annually, such trust to be referred to in this section as an 'express total return unitrust'.

(b) The unitrust amount for an express total return unitrust may be determined by reference to the fair market value of the trust's assets in one year or more than one year.

(c) Distribution of such a fixed percentage unitrust amount is considered a distribution of all of the income of the express total return unitrust.

(d) An express total return unitrust may or may not provide a mechanism for changing the unitrust percentage similar to the mechanism provided under §3527 of this title, based upon the factors noted therein, and may or may not provide for a conversion from a unitrust to an income trust and/or a reconversion of an income trust to a unitrust similar to the mechanism under §3527 of this title.

(e) If an express total return unitrust does not specifically or by reference to §3527 of this title deny a power to change the unitrust percentage or to convert to an income trust, then the trustee shall have such power.

(f) The distribution of a fixed percentage of not less than three (3) percent nor more than five (5) percent reasonably apportions the total return of an express total return unitrust.

(g) The trust instrument may grant discretion to the trustee to adopt a consistent practice of treating capital gains as part of the unitrust distribution, to the extent that the unitrust dis-

---

[154] *See* n. 93, *supra.*

[155] These states might include Colorado, Indiana, North Carolina and Virginia. It could also provide guidance to those states more closely aligned with the wording of the Illinois statute, the key difference being that Illinois and others following Illinois have a default unitrust rate, with a range of 3-5% allowable with the consent of the trustee and the beneficiaries, while Delaware's statute gives the trustee the power to choose within that range with notice to but not consent of the beneficiaries required.

tribution exceeds the net accounting income, or it may specify the ordering of such classes of income.

(h) Unless the terms of the trust specifically provide otherwise, a distribution of the unitrust amount from an express total return unitrust shall be considered to have been made from the following sources in order of priority:

(1) from net accounting income determined as if the trust were not a unitrust;

(2) from ordinary income not allocable to net accounting income;

(3) after calculating the trust's capital gain net income as described in I.R.C. §1222(9), from net realized short-term capital gain as described in I.R.C. §1222(5) and then from net realized long-term capital gain described in I.R.C. §1222(7); and

(4) from the principal of the trust.

(i) The trust instrument may provide that:

(1) assets for which a fair market value cannot be readily ascertained shall be valued using such valuation methods as are deemed reasonable and appropriate; and

(2) assets used by a trust beneficiary, such as a residence property or tangible personal property, may be excluded from the net fair market value for computing the unitrust amount.

Section 14. This Act shall be effective upon enactment and shall apply to trusts whenever created.

Note that in 2005 Delaware also adopted the power to adjust,[156] and in doing so adopted an ordering rule for adjustments from principal to income, making it the only state to have expressly dealt with this issue in the context of the power to adjust.

The foregoing amendments to Delaware's statutes make their total return statutes perhaps the most flexible available at the present time. Note that if one took the view that for an ordering rule to be respected, that it really must be in both the governing instrument and in an applicable state statute, then the default rule should be that the trustee should have discretion, rather than the ordering rule set forth above. The ordering rule has the advantage of making the process simpler for the trustee, unless the drafter has selected a trustee who desires to fine tune the planning to the maximum extent. For both the power to adjust and the power to convert to a unitrust, the most likely choice is going to be to treat the income as being distributed in the order set forth above.

For the power to adjust, some commentators would view the ability to "steer" the capital gains in one direction or another to be an advantage.[157] This author views it as more frequently akin to having two steering wheels—necessary for a fire truck but otherwise probably more confusing than beneficial. The power to adjust has the inherent flexibility to raise or lower the adjustment to take into account the tax characteristics of the adjustment and the distribution. For most circumstances, that is all the flexibility that you need and all that is helpful.

c. Pennsylvania Style Statutes. A total of seven state statutes have drawn significantly on the Pennsylvania model.[158] As discussed previously,[159] the language governing notice to beneficiaries must be changed to include all parties in interest. The following, drawn from language in the Uniform Trust Act, is suggested:

> (2) The trustee gives written notice of the trustee's intention to release the power to adjust and to convert the trust into a unitrust and of how the unitrust will operate, including what initial decisions the trustee will make under this section, to all the *sui juris* beneficiaries who:
>
> (i) are currently eligible to receive income from the trust; [and]
>
> (ii) would be eligible to receive, if no powers of appointment were exercised, income from the trust if the interest of all those eligible to receive income under subparagraph (i) were to terminate immediately prior to the giving of notice; and
>
> (iii) would receive, if no powers of appointment were exercised, a dis-

[156] *See* 12 Del. Code §6113(h). For quick reference, *see* http://www.delcode.state.de.us/title12/c061/index.htm#TopOfPage

[157] *See* Blattmachr and Gans, *supra* n. 93, at 915.

[158] Alaska, Maine, Maryland, New Hampshire, Oregon and Washington.

[159] *See* text discussion at n. 66.

tribution of principal if the trust were to terminate immediately prior to the giving of notice.

Only two of the three beneficiary classes should be required to contain a *sui juris* beneficiary:

> There is at least one *sui juris* beneficiary under paragraph (2)(i) and at least one *sui juris* beneficiary under either paragraph (2)(ii) or (2)(iii).

A suggested form of revision for the Pennsylvania statute as it related to express total return unitrusts follows. While a proposal different from the following has been made in Bill form in Pennsylvania,[160] the author believes that the following represents a better starting point for such a statute, which as one can see is very similar to what was adopted in Delaware.

> Express Total Return Unitrusts. The following provisions shall apply to a trust which by its governing instrument requires the distribution at least annually of a unitrust amount equal to a fixed percentage of not less than three nor more than five percent per year of the net fair market value of the trust's assets, valued at least annually, such trust to be referred to as an "express total return unitrust":
>
> (a) The unitrust amount may be determined by reference to the net fair market value of the trust's assets in one year or more than one year.
>
> (b) Distribution of such a fixed percentage unitrust amount is considered a distribution of all of the income of an express total return unitrust and shall be considered to be an income interest
>
> (c) Such a distribution of the fixed percentage of not less than three percent nor more than five percent is considered to be a reasonable apportionment of the total return of an express total return unitrust.
>
> (d) An express total return unitrust which provides for a fixed percentage payout in excess of five percent per year shall be considered to have paid out all of the income of the express total return unitrust, and to have paid out principal of the said trust to the extent that the fixed percentage payout exceeds five percent per year.
>
> (e) The governing instrument may grant discretion to the trustee to adopt a consistent practice of treating capital gains as part of the unitrust distribution, to the extent that the unitrust distribution exceeds the income determined as if the trust were not a unitrust, or it may specify the ordering of such classes of income.
>
> (f) Unless the terms of the trust specifically provide otherwise, a distribution of the unitrust amount shall be considered to have been made from the following sources in order of priority:
>
> (1) from net income determined as if the trust were not a unitrust;
>
> (2) from ordinary income not allocable to net income;
>
> (3) from net realized short-term capital gains;
>
> (4) from net realized long-term capital gains; and
>
> (5) from the principal of the trust estate.
>
> (g) The trust document may provide that assets used by the trust beneficiary, such as a residence property or tangible personal property, may be excluded from the net fair market value for computing the unitrust amount. Such use may be considered equivalent to the "income" or unitrust amount.
>
> §8108. Power to Treat Gains as Part of a Distribution of Principal. Unless prohibited by the governing instrument or specifically addressed by the provisions of Section 8105(f) or Section 8107, the trustee of a trust shall have the power to consider gains from the sale of capital assets in the trust to be part of a distribution of

[160] SB660. For quick reference, *see* http://www.legis.state.pa.us/WU01/LI/BI/BT/2005/0/SB0660P1423.HTM.

> principal to a beneficiary, and if such power is exercised, such gains shall be treated consistently by the trustee on the trust's books, records and tax returns as part of a distribution to a beneficiary.

What the foregoing would do is to provide clear and specific statutory support for a drafter of a unitrust, and would provide significant freedoms to her:

> 1. It would expressly allow a distribution of 3% to 5% to be defined as income. This is appropriate without court approval because it is the drafter and settlor who are making the rate decision.
>
> 2. It allows the freedom to use a 3 year smoothing rule, or a 5 year rule, or no rule at all. This sort of a technical difference is not fundamental to the concept, and thus it should be allowed, as it is in the Regulations.
>
> 3. A payout of more than 5% is categorized as a distribution of principal to the extent that it exceeds 5%, while the first 5% is considered to be a distribution of all of the income of the trust.
>
> 4. Freedom to give the trustee the discretion of including capital gains in the unitrust distribution or not is granted, but if it is not exercised, the ordering rule is imposed.
>
> 5. Note that "ordinary income" apart from accounting income is placed in the rule. This seems appropriate, and consistent with the law and practice prior to the "income" revolution. It may be helpful if IRD is paid into the trust to avoid unfortunate results because of telescoping of the income tax brackets.
>
> 6. "Use" property is expressly excluded from the unitrust computation if this is desired by the drafter, which often it is. The "use" should be the substitute for the unitrust amount for property such as the residence property which may be held within a marital trust for the spouse.

d. States with No Unitrust Conversion Statute. For states that have no unitrust conversion statute, but wish to give drafters and settlors as much freedom to craft trusts as they choose, they might want to follow the lead of Texas which adopted a unitrust definition of income in a way that is believed to be consistent with the Regulations without going so far as to provide a unitrust conversion statute. The following language might well address that intent:

> Total Return Unitrusts-Alternative Definition of Income—The following provisions shall apply to a trust which by its governing instrument requires the distribution at least annually of an amount equal to a fixed percentage of not less than three nor more than five percent per year of the net fair market value of the trust's assets (the "unitrust amount"), valued at least annually, such trust to be referred to as a "total return unitrust":
>
> 1. The unitrust amount may be determined by reference to the net fair market value of the trust's assets in one year or more than one year.
>
> 2. Distribution of such a fixed percentage unitrust amount is considered a distribution of all of the income of the total return unitrust and shall not be considered a fundamental departure from applicable state law.
>
> 3. Such a distribution of the fixed percentage of not less than three percent nor more than five percent is considered to be a reasonable apportionment of the total return of a total return unitrust.
>
> 4. A total return unitrust which provides for a fixed percentage payout in excess of five percent per year shall be considered to have paid out all of the income of the total return unitrust, and to have paid out principal of the said trust to the extent that the fixed percentage payout exceeds five percent per year.
>
> 5. The governing instrument may or may not grant discretion to the trustee to adopt a consistent practice of treating capital gains as part of the unitrust

distribution, to the extent that the unitrust amount exceeds the net accounting income, or it may specify the ordering of such classes of income.

6. Unless the terms of the trust specifically provide otherwise, or grant discretion to the trustee as set forth above, a distribution of the unitrust amount shall be considered to have been made from the following sources in order of priority:

(a) from net income determined as if the trust were not a unitrust;

(b) from ordinary income not allocable to net income;

(c) from net realized short-term capital gains;

(d) from net realized long-term capital gains; and

(e) from the principal of the trust estate.

9. The trust document may provide that assets used by the trust beneficiary, such as a residence property or tangible personal property, may be excluded from the net fair market value for computing the unitrust amount. Such use may be considered equivalent to the "income" or unitrust amount.

e. Consider Clarifying the Rules Concerning Retirement Accounts. As discussed previously, the rules concerning retirement accounts should be addressed specifically, and in light of the Final Regulations and Revenue Ruling 2006-26, it would be well to consider some alterations of Section 409 of the Uniform Act or whatever version of those rules have been adopted in your state. Pennsylvania's provision might be a place to start:

§8149. Retirement benefits, individual retirement accounts, deferred compensation, annuities and similar payments.

(a) General rule.—

(1) The trustee shall allocate to income the greater of:

(i) the portion of a payment characterized by the payor as interest or a dividend or a remittance in lieu of interest or a dividend; or

(ii) the portion of the payment characterized as imputed interest for Federal income tax purposes.

(2) The balance of any such payment shall be allocated to principal.

(b) Allocation under contract calling for equal installments.—

(1) If no part of a payment under a contract calling for equal installments over a fixed period of time is allocable to income under the provisions of subsection (a), the difference between the trust's acquisition value of the contract and the total expected return shall be deemed to be interest.

(2) The trustee shall allocate to income the portion of each payment equivalent to interest on the then unpaid principal balance at the rate specified in the contract or a rate necessary to thus amortize the difference between the expected return and the acquisition value, where that rate is readily ascertainable by the trustee.

(c) Allocation when internal net income of fund is readily ascertained.—

(1) If no portion of a payment from a separate fund held exclusively for the benefit of the trust is allocable to income under subsections (a) and (b) but the internal net income of the fund determined as if the fund were a separate trust subject to Subchapters B (relating to decedent's estate or terminating income interest) through E (relating to allocation of disbursements during administration of trust) is readily ascertainable by the trustee, the portion of the payment equal to the then undistributed net income of the fund realized since the trust acquired its interest in the fund shall be deemed to be a distribution of such income and shall be allocated to the trust income account.

(2) The balance of any such payment shall be allocated to principal.

(d) When not otherwise allocable to income.—

(1) The trustee shall allocate to income 10% of the part of the payment which is required to be made during the accounting period and the balance to principal if:

(i) no part of the payment is allocable to income under subsection (a), (b) or (c); and

(ii) all or part of the payment is required to be made.

(2) The trustee shall allocate the entire payment to principal if:

(i) no part of a payment is required to be made; or

(ii) the payment received is the entire amount to which the trustee is entitled.

(3) For purposes of this subsection, a payment is not "required to be made" to the extent that it is made because the trustee exercises a right of withdrawal.

(e) Allocation to obtain marital deduction.—If, to obtain a Federal estate or gift tax marital deduction for a trust, the trustee must allocate more of a payment to income than provided for by this section, the trustee shall allocate to income the additional amount necessary to obtain the marital deduction.

(f) Application.—This section does not apply to payments to which section 8150 (relating to liquidating asset) applies.

(g) Definition.—In this section, "payment" means a payment that a trustee may receive over a fixed period of time or during the life of one or more individuals because of services rendered or property transferred to the payor in exchange for future payments. The term includes all of the following:

(1) A payment made in money or property from:

(i) the payor's general assets; or

(ii) a separate fund created by the payor or another.

(2) A payment on or from:

(i) an installment contract or note;

(ii) a private or commercial annuity;

(iii) a deferred compensation agreement;

(iv) an employee death benefit;

(v) an individual retirement account; or

(vi) a pension, profit-sharing, stock or other bonus, or stock-ownership plan.

Pennsylvania Comment: Section 8149. Where the actual interest or its equivalent on the unpaid principal balance is specified or can be easily calculated it seems counterintuitive to resort to an arbitrary 10% rule, which in those cases severely distorts economic reality. Subsections (a) and (b) would provide such specific apportionment for notes or other installment contracts calling for level payments, a portion of which would be credited to interest on the then unpaid principal balance and the remaining portion to principal itself. A term certain annuity readily lends itself to the same amortization concept since the difference between the total expected return and the original acquisition value is substantially the equivalent of interest. Although an annuity conventionally does not specify an interest rate, both the effective interest rate and the resulting contract amortization schedule will be readily ascertained since in most cases it will be the same as the Applicable Federal Rate used in determining the acquisition value. Even in other cases, the unspecified interest rate can be readily ascertained from the acquisition value and the amount, frequency and duration of payment factors using one of many loan amortization programs commonly available in both financial software and on the Internet. Most trustees or custodians of Individual Retirement Accounts (IRAs) and segregated 401(k) or HR-10 accounts render periodic statements which clearly reflect the interest and dividend income earned by the fund. Apportionment based on a presumed "pass through" of this income comes far closer to economic reality than an arbitrary allocation of 10% of a distribution which can range more or less from 1.3% to 50% of the underlying fund assets. The presumption as to the source of a distribution should resolve the problem of undistributed income identification where the retirement plan keeps all assets in a single pot. It will also aid in identification of when and by whom an IRC 691(c) deduction may be claimed. Thus principal which bore the burden of the tax should enjoy the full benefit of the deduction therefor.

The foregoing provisions should avoid the issue for IRA's discussed previously of trying to determine what the income is and is not required to be in order to satisfy the Final Regulations under Section 643 and the all-important marital deduction, and it fits neatly into Ruling 2006-26. In addition, for a unitrust state, it makes sense to tie in the definition of income on a retirement account payable to a trust where the trust has been converted or is drafted as a unitrust, so that the state law is clear on the matter. The following might accomplish that result:

> Retirement Benefits payable to a unitrust. Where retirement benefits are payable to a trust converted to a unitrust under Section 8105, or to an express total return unitrust under Section 8107, income of the retirement account shall be determined as set forth in Section 8149, and where 8149(c) applies, it shall be determined as if the retirement account were a separate trust. In the case of the trust which has been converted to a unitrust the trustee elects to determine the income from such a benefit by a percentage of the market value of the retirement account, in which case the unitrust rate shall be 4%, or such other rate as established in such conversion proceeding by the court, or unless the governing instrument provides for a unitrust payout from the retirement account in the case of an express total return unitrust. If the income from a retirement account is elected to be determined on a unitrust basis, the unitrust amount may be calculated based upon the market value of the retirement account over one or more years.

Generally speaking, it may be best to leave the old conventional definition of income in place for an IRA payable to a unitrust so as not to cause an increase in the distributions from the IRA to the trust, increasing income tax to the trust and/or the trust beneficiary in the bargain. However, if under all of the circumstances it is determined that the old "income" rule might cause difficulty in investing the IRA appropriately, as, for example, in a high-interest rate period, or where the higher unitrust "income" is needed by the surviving spouse, then giving the trustee the option of converting to a unitrust both with regards to the trust and to the IRA "trust within a trust" may be helpful flexibility. Without this clarification, the treatment under many state statutes may not be as clear as we might like Revenue Ruling 2006-26 teaches us the importance of creating and preserving the marital deduction separately for the IRA and the marital trust into which it pours, so it is best if the applicability of the unitrust statute to the IRA and the trust is made as explicit as possible.

E. DOES IT ALL REALLY MATTER? IS TOTAL RETURN INVESTING AND DISTRIBUTING STILL RELEVANT?

But does all of this really matter anymore, now that we know that the investment total return trees do not grow to the sky and that a price/earnings ratio of 40 to 1 for the S & P 500, as it was in the year 2000, is neither sensible nor sustainable? The dividend yield on the S & P 500 is still well under 2%, specifically 1.79% at the present time, and while interest rates have been rising and the 10 year treasury bond yield is up to 5.06%, a 50/50 mix of the two would yield 3.4% before trustee's fees and 2.8% to 3.0% after trustees' fees, depending upon the amount of trustee's fees and the allocation as between income and principal. This would leave one with a net income production of something like $29,000 on a million dollar trust given a 50/50 asset allocation, which, as was discussed at the beginning of this article, is an asset allocation that is virtually doomed to fail in the quest of preserving or building real value in the family trust.

One would think that the effects of JGTRRA, with its 15% tax rate for qualifying dividends, would be to increase the emphasis on dividends from stocks substantially, and there are those who are adherents to that quite logical point of view.[161] And indeed there has been strong growth in both earnings and dividends and a substantial growth in the number of S & P 500 stocks that pay dividends. At present, about 75% of all of the S & P 500 stocks pay a dividend, an increase from the year 2001, when only 70% paid a dividend, but comparing rather poorly with the 94% that paid dividends in 1980.

In terms of performance, there is very little, if any, evidence favoring the dividend paying stocks in the S & P 500. If fact, they have significantly underperformed their non-dividend paying brethren as of April 2006:[162]

	Average S&P 500 Payers	Average S&P 500 Non-payers
Month—average change	1.24%	0.16%
Year-to-date—average change	6.99%	8.75%
12-months	20.61%	31.2%
Issues	385	115

And while there is definitely a trend towards higher dividend payouts, the increase in the S & P 500 dividend payout over the 12-month period ending December 31, 2005, was 14% over the same calculation one year earlier, while earnings were also up 14% for the

[161] *See* "The Dividend Revolution," *PNC Advisor's Investment Outlook*, (Spring 2005).

[162] Data taken from Standard & Poors' Website, www.standardandpoors.com.

same period. So while the dividend yield has clearly increased considerably since its low point in the year 2000, it is a very long way from its historical average of over 4% and seems unlikely to reach that level anytime soon. And share buybacks are using up corporate cash at perhaps a higher rate than dividend increases. In 2004 a total of $197 billion was spent on share buybacks by companies in the S & P 500, while in the first half of 2005 alone, there was a total of $163 billion.[163] At the same time, it is interesting to note that the total dividend payout of the S & P 500 for the 12 months ending September 30, 2005, was $196.7 billion. So the large companies which are in the best position to pay substantial dividends are still using more cash buying back their own shares than paying out a healthier stream of dividends.

The trends that caused the "income" problem to begin with have diminished a bit, but are still very significant. But the need for a total return investment and distribution policy for trusts does not depend upon this "problem." At all times, and in all markets, it is critical that trustees be able to invest for total return without having to worry about whether the choice of investment favors the current beneficiary or favors the remainder beneficiary, because what the "income" beneficiary receives is defined by what satisfies the traditional definition of income. The issues of total return investing and distributing the family trust are very much still with us.

[163] *Intel Ups Dividend Plans $25B Buyback,* Associated Press, November 10, 2005, as published by America On Line.

Standards of Prudence and Management of the Insurance Portfolio
(Part 2 of 4)

by Kathryn A. Ballsun, *Los Angeles, California*
Patrick J. Collins, *San Francisco, California, and*
Dieter Jurkat, *San Raphael, California**

The second of a four-part series on the administration of life insurance as an asset of a trust. The first part discusses the duties of trustees under different models for administering an irrevocable life insurance trust. The second part examines the impact of the Prudent Investor Rule on holding life insurance in a trust. The third part will describe one approach that trustees may take in evaluating the appropriateness of insurance as an asset in a particular trust. The final part deals with decisions that will be faced by trustees when life insurance is held in a trust.

PART 2: STANDARDS OF PRUDENCE AND MANAGEMENT OF THE INSURANCE PORTFOLIO

Part 2 of this article provides insight into the skill sets required by trustees wishing to retain investment management functions; Part 3 illustrates a tool that those charged with the task of policy evaluation can employ to facilitate prudent asset selection as well as ongoing monitoring and surveillance; Part 4 offers a method to document the prudence of asset management decision making, and to enhance the ability of the trustee to set and review the terms of the insurance asset management delegation.

Asset management responsibilities of an ILIT trustee commonly can be segregated into two distinct parts. The first part is the purchase of the life insurance policy. Often, the reality is that the trustee only nominally purchases the policy that the trust settlor selects. Given the proper documentation, the trustee's responsibility with respect to the purchase traditionally has been regarded as minimal because the settlor is the moving force behind the purchase. Such an attitude of well being, however, may no longer have a solid basis in fact or practice. In a modern day scenario, if the trustee is the listed purchaser, the trustee may have to bear the full burden for the purchase decision. The reality of the settlor's acts and words of assurance may not provide a sufficient shield to charges of trustee breach of duty.

The second part of asset management is the ongoing monitoring and evaluation responsibilities that the trustee assumes once the policy becomes an asset of the irrevocable trust. If future policy benefits are not

Kathryn Ballsun is a member of ACTEC and is a practicing estate planning, probate and trust attorney in Los Angeles, California. Patrick Collins is a principal in the Independent Investment Counsel firm of Schultz Collins Lawson Chambers, Inc. in San Francisco, California; Baltimore, Maryland; and Washington D.C. Dieter Jurkat is director of information technology and senior actuarial consultant for Firemans Fund Insurance Company in San Raphael, California.

forthcoming, trust beneficiaries may make inquiries regarding the process by which the trustee managed the ILIT's assets, and may assess the trustee's use of care, skill and caution in the stewardship of wealth.

§2.1 HISTORICAL BACKGROUND REGARDING ADVICE TO ILIT TRUSTEES

A survey of the literature following the 1992 publication of Restatement Third reveals several articles suggesting that life insurance is a "fiduciary" asset that requires the trustee to devote a level of care, skill and caution comparable to other traditional investments (*e.g.,* stocks and bonds).[1] With respect to Restatement Third, life insurance and annuity products are referenced in the Reporter's comment *(k)*:

> …an annuity may offer a reasonable means of seeking to assure that a trust's periodic distribution requirements can be met; or, the acquisition and maintenance of a life insurance policy may fit within the trust purposes as an appropriate type of benefit or protection for one or more beneficiaries….in selecting an investment with due prudence, the trustee must examine and weigh numerous factors about the asset and the trust circumstances, with care and skill, and with an eye toward an overall level of caution or conservatism appropriate to the trust at the time the investment is made. Among the characteristics a trustee should consider in examining a contemplated investment are the following: (1) Expectations concerning the investment's total return…; (2) The degree and nature of risks associated with the investment…; (3) The marketability of the investment; (4) Transaction costs…; and, (5) Any special characteristics of the investment that affect its risk-reward tradeoffs and effective return….[2]

Although, in general, commentaries on management of trust-owned assets address the five investment characteristics, there is little written advice that explicitly and comprehensively addresses the practical implications for ILIT insurance policy management. The literature often leaves the trustee in doubt about how to determine the expected return of a life insurance program, the degree and nature of the risks associated with the program, the lack of marketability for life insurance contracts, the economic consequences of high transaction costs, and the special characteristics of the insurance contract. Although some articles on trust-owned life insurance provide insight into legitimate and important issues related to selection of insurance contracts, or into ongoing evaluation of policies, the discourse often reflects the perspective of insurance sales organizations seeking to increase new sales or policy replacement sales. Historically, insurance policy management articles advise trustees to consider the following questions:

- What is the financial condition of the carrier?
- Are the current premiums sufficient to support projected future benefits?
- When should a policy be replaced?

Many articles speak to the issues of reasonable care and diligence in the acquisition of new insurance policies. In the parlance of the insurance industry, this effort is termed "due care" analysis in order to distinguish it from "due diligence," which is a term associated with the securities industry.[3]

---

[1] *See,* for example, Maurer, David V., "Irrevocable Life Insurance Trusts: Good Business For Banks?" *Trusts & Estates* (May, 1992), pp. 24-32; Whitelaw, C. Markham and Culver, David M., "Managing Trust-Owned Life Insurance Policies," *Trusts & Estates* (April, 1993), pp. 46-48; Donohue, Mark T., "Unexpected Liability Awaits Many Trustees of Life Insurance Trusts," *Trusts & Estates* (April, 1994), pp. 43-46; Daiker, Stephen B., "Insurance Trusts Require Careful Set-Up and Follow-Up," *Taxation For Accountants* (August, 1994), pp. 106-112; Bertles, James B. and Yudenfreund, Joel H., "Limiting Fiduciary Liability for Investing in Life Insurance," *Journal of Taxation of Investments* (Spring, 1994), pp. 239-247; Schwartz, James D., Netzorg, Gordon W. and Bernhardt, Susan, "Due Diligence In Life Insurance Selection," *Probate & Property* (March/April, 1994), pp. 39-42; Steuer, Anthony, "A Duty to Advise," *Best's Review* (December, 1999), pp. 81-83; Rybka, Lawrence J., "Insurance Policy Selection for Irrevocable Life Insurance Trusts: New Challenges for Trustees and Advisors," *Trusts & Estates* (February, 2002), pp. 44-50; Leimberg, Stephan R. and Gibbons, Albert E., "Performing Due Diligence With Respect to Life Insurance Trusts is Crucial," *Estate Planning* (May, 2003), pp. 248-251.

[2] Restatement (Third) of Trusts: Prudent Investor Rule.

[3] In addition to regulatory monitoring conducted primarily by state insurance departments, due care investigations with respect to a carrier's financial stability are also conducted by independent rating services such as the A.M. Best Co., Moody's, Fitch Ratings and Standard & Poor's. These companies issue evaluative reports based on both a quantitative and qualitative examination of carrier operations and financial disclosures. The Government Accounting Organization (GAO) detailed and evaluated rating company methodologies in their report to the House of Representatives Subcommittee on Commerce, Consumer Protection, and Competitiveness Committee on Energy and Commerce (Briefing Report, 09/29/94, GAO/GGD-94-204BR): *Comparison of Private Agency Ratings for Life/Health Insurers.*

Concern for due care greatly increased following the seizure by regulators of Executive Life of California in April 1991 and Mutual Benefit Life in July 1991. At the time of regulatory actions, both insurance carriers were among industry leaders with respect to both sales and assets. The public pondered the likelihood of a new Savings and Loan crisis, and the insurance industry faced the prospect of a disastrous sales decline due to erosion of public confidence. Insurance agents incorporated demonstrations of the financial health and long-term stability of insurance underwriters into their sales presentations lest their customers fail to give promised benefits sufficient credence.

Due care is therefore, in part, the attempt to pick a company that will outlive the insured by investigating a range of financial data and actuarial performance measures. As the perceived need for adequate due care investigation grew, so also did the burden on ILIT trustees. Life insurance vendors became eager to present selectively chosen financial and actuarial performance data while, concurrently, suggesting that critical examination of such data is crucial for making an informed insurance purchase decision. The ILIT trustee was now asked to put on an economic forecasting hat with the objective of picking good insurance companies. If selecting stock and bond investments under conditions of uncertainty is difficult, the task of projecting insurance company financial performance on the basis of publicly reported statutory accounting data is an even more formidable task.

Following the failure of major life insurance companies in the late 1980s and early 1990s, insurance industry representatives authored many due care articles. In general, several, usually implicit, assumptions inform the advice:

1. The letter and number grades assigned to carriers by independent rating agencies are of only limited value when comparing the financial strength of two or more companies;
2. Other publicly available information (*e.g.,* filings with state insurance departments or with the Securities and Exchange Commission) provides an expanded data set sufficient to formulate judgments about both insurance companies as well as about the products sold by them; and,
3. Agents, acting in the capacity as insurance counselors, can readily access this data and, therefore, are credible information sources for trustees.

When, in 1992, highly publicized hearings of the U.S. Senate Committee on the Judiciary confirmed that more than 90 percent of the insurance programs sold in the 1980s were unlikely to generate the values projected on policy sales illustrations, due care analysis expanded beyond the attempt to evaluate a carrier's financial strength, to an evaluation of the credibility of the carrier's sales illustrations.[4] If mastery of insurance company financial statement analysis was a requirement for due care with respect to carrier solvency, the ILIT trustee was now asked to contemplate the reasonableness of actuarial assumptions underlying the pricing of individual insurance products. Due care standards for evaluation of individual policy illustrations were set, in part, by the Society of Financial Services Professionals (formerly, the Society of CLU/ChFC). During the mid 1990s, companies offering life insurance products voluntarily supplied information about their products and pricing assumptions on standardized questionnaires developed by the Society.[5]

§2.2 AN IMPOSSIBLE BURDEN FOR THE ILIT TRUSTEE

Due care was becoming a complex and formidable undertaking. In this atmosphere, the life insurance industry seized an opportunity to provide a greatly needed service by having its representatives write due care articles, present due care seminars, and provide financial statement information to prospective consumers. The insurance sales agent evolved into the insurance advisor; and, commissions are earned not solely because the agent motivates the client to "do the right thing" (*i.e.,* buy insurance) but because the agent is a source of and interpreter for due care information that is critically important to the life insurance buyer.

A curious phenomenon developed whereby the industry to be evaluated established the criteria for such evaluation. Presentations and interpretations of comparative financial and actuarial information enhanced the image of the insurance agent and provided a veneer of academic and professional responsibility that served to allay public concerns regarding the sales practices of insurance companies. But development of evaluative criteria had its roots primarily in the need to permit insurance purchases to continue in a marketplace saturated with skeptical consumers.

Anecdotal evidence suggests that trustees began to paper their files with the due care materials provided

[4] "Consumer Disclosure In Insurance Sales," Senate Hearing 102nd Congress Subcommittee on Antitrust, Monopolies and Business Rights (June 23, 1992). *See also* McNamee, M., "Life Insurance: So You Think You're Covered," *Business Week* (August 30, 1999).

[5] The Society of Financial Services Professionals (www.financialpro.org) has discontinued sponsorship of this program.

by insurance agents and carrier home offices.[6] However, whenever commercially produced sales materials become the basis of a fiduciary's decision-making process, trustees may be invited to explain, in court, the prudence of their asset management procedures. Unfortunately, as many commercial and professional trustees followed the due care path laid out by the insurance industry, they gave themselves an impossible task. Trustees implicitly communicated to beneficiaries and other interested parties that they possessed the data and analytical skills sufficient to forecast carrier solvency and policy performance.

However, at the same time that due care advice flowed from the insurance practitioner community to the trust and estate-planning community, independent research studies published in academic journals indicated the great difficulties in solvency prediction and policy performance forecasting. Trustees and insurance agents worked collaboratively to pick the best insurance policy with little evidence that either group possessed the forecasting skills necessary to identify the companies or policies that will still exist twenty or thirty years in the future. ILIT administration entered into an era in which trustees attempt to do the impossible (pick winning insurance contracts) while forsaking the more fundamental tasks of prudent portfolio design, implementation and monitoring according to reasonable guidelines communicated, in writing, to interested parties. Although, by following the path laid out by traditional due care advisors, trustee success becomes a function of forecasting skills, the trustee cannot always be right. The trustee, however, can always be prudent. ILIT administration should require prudence and not ask the trustee to shoulder an unbearable burden.

Much of the conventional, practitioner-oriented wisdom of due care was codified in the 1994 edition of *The Insurance Counselor: Life Insurance Due Care* published by the American Bar Association.[7] The comprehensive 360-page text states that "due care enables the advisor to recommend an informed carrier and policy choice." It is important to reiterate that the majority of due care advice literature does not concern itself directly with the legal and academic ("modern portfolio theory") requirements for care, skill and caution enumerated in Restatement Third; and, in fact, *The Insurance Counselor* states that "it is not intended to express or imply a legal standard of due care."[8]

It was inevitable that the due care literature flowing from the insurance industry would have profound effect on trustees faced both with the task of administering a complex financial instrument, and with the need to assure compliance with fiduciary standards set forth in Restatement Third. If life insurance is a fiduciary asset, and if, as the Restatement Third states, "the duty of care requires the trustee to exercise reasonable effort and diligence in making and monitoring investments for the trust,"[9] then it is reasonable to expect that failure to evidence reasonable due care may result in significant liability exposure. Avoidance of liability is a common theme within the

---

[6] The authors (bound by confidentiality agreements) are aware of at least one case where a defendant (bank trust department) represented, in writing, to the settlor of an ILIT that they had performed "thorough due diligence" on the carrier that underwrote the coverage on a trust-owned insurance contract. The due diligence consisted of benefit projections on a carrier-generated computer illustration plus a ratings comparison and an unadjusted accounting data checklist provided by a software subscription to a turnkey information vendor. Based on this self-styled thorough and independent investigation, the trustee elected to place all coverage with a single company; and, as a by-product of the decision, collected substantial commission income from the carrier.

[7] Schwartz, Richard A. and Turner, Catherine R., "The Insurance Counselor: Life Insurance Due Care Carriers, Products, and Illustrations," *Section of Real Property, Probate and Trust Law*, American Bar Association (Second Edition, 1994). At the New Orleans August 8, 1994 ABA conference on Understanding Sales Illustrations: How to Avoid Liability for Life Insurance Product Selection, *The Insurance Counselor* received the following endorsement: "If you decide to exercise the Highest Level of Due Care: You need to acquire expertise in life insurance. To do so, order 'The Life Insurance Counselor, Life Insurance Due Care, Carriers, Products, and Illustrations,' Second Edition…." This is a curious statement because the book clearly states that it is not intended to make its readers experts in life insurance. Furthermore, the ABA conference course study material ("Checklist for Lawyers Working with Life Insurance Agents") continues, "If you plan to follow the Prudent Man Approach: Seek out local life underwriters who have the necessary expertise and rely on their advice." The Prudent Man approach, as embodied in Restatement Second, has an anti-delegation provision that would seem to invalidate this advice.

Chapter Seven of *The Insurance Counselor* is a particularly good example of customary methods used to compare life insurance policy illustrations. For additional examples of advice on evaluation of life insurance policy illustrations, see Puelz, Robert, "A Process for Selecting a Life Insurance Contract," *The Journal of Risk and Insurance* (March, 1991), pp. 138-146; Rubin, John, "How To Recommend A Policy To a Client," *Trusts & Estates* (May, 1990), pp. 49-53; Hill, Alfred H., "Insurance From The Estate Planners' Perspective," *Trusts & Estates* (June, 1990) pp. 73-77; Parrish, Stephen B. and Stephens, Dale R., "With All Due Care," *Best's Review* (June, 1992), pp. 59-117.

[8] *Id.,* p. 3.

[9] Restatement (Third) of Trusts, *supra* at Section 227, comment d.

advice literature and is an emerging issue for the ILIT trustees.[10]

§2.3 OBSTACLES TO WORKING WITH INSURANCE AGENTS AND FINANCIAL PLANNERS

The life insurance agents' rush to fill the need for due care analysis may cause difficulties for prudent ILIT administration because often the only easily accessible source of due care information is an agent who is pursuing a sales objective. Difficulties present themselves on several fronts:

1. High agent turnover makes it problematic that the trustee can rely on continued availability of the information source. One estimate is that approximately 95% of trust-owned life insurance policies have no assigned servicing agents;[11]
2. Agents are not disinterested sources of information because they have a financial stake in the insurance programs under evaluation.[12] It is not certain that an agent will alert a trustee to the possibility that the policy may no longer be prudent and suitable;
3. Agents may have a primary duty to their employers as defined under the fair trade practice standards embodied in each state's Insurance Code. In some instances, the duty to promote and develop employer business interests may bear an uneasy relationship with a trustee's fiduciary duties;
4. Agents (as well as trust-service marketing departments) may have a vested interest in policy replacement;[13]
5. Agents are not trained in certain areas of financial analysis vital for preparation, interpretation and evaluation of relevant data.[14]

Although agents may present unadjusted financial statement data to prospective buyers, the mere presentation of unadjusted, vendor-disclosed data is neither informed interpretation nor critical evaluation. The import of financial information emerges only from the broader financial context from which the information flows. Consideration of bits of financial data in isolation from their appropriate context may lead to improper conclusions because insurance companies no longer share common approaches to product manufacturing, business development and company management. As Terence Lennon from the New York State Insurance Department remarks:

> When companies were more stable and more comparable to each other, the regulators used ratios, for example, percentage of capital to assets. In those days, you could fairly say that a

[10] *See*, for example, Maurer, D. V., *supra* at 28: "…if the trustee of the ILIT purchases a life insurance policy from a company which later becomes insolvent, the trustee could be held liable for the loss of the insurance proceeds. There might also be liability for the premium payments which have been made over the years…. As purchaser of the policy, the bank becomes potentially liable for the solvency of the insurer, just as it would if it had purchased stock." The problem of liability for commercial trustees is particularly acute: "If the trustee either possesses, or has represented that he possesses, greater skill than that of a person of ordinary prudence, liability will follow for losses resulting from a failure to use greater skill." Richwine, G. Michael, "How Individual Trustees Can Avoid Liability and Breaches of Trust," *Estate Planning* (December, 1997), p. 484.

[11] King, Carole Ann, "Are Agents Off The Hook on Trust-Owned Life?" *National Underwriter* (November 13, 2000). Roughly 70% of agents hired both by exclusive agency systems and non-exclusive ("broker") systems fail to stay in the industry beyond four years. Moore, James F. and Santomero, Anthony M., "The Industry Speaks: Results of the WFIC Insurance Survey," *Changes in the Life Insurance Industry: Efficiency, Technology and Risk Management,* Second Edition (Kluwer Academic Publishers, 2002), p. 52. Between 1998 and 2001, there was a net loss of 17,000 life insurance agents. Woods, David F., "The Future of Life Insurance," *Journal of Financial Service Professionals* (January, 2005), p. 45.

[12] Morgenson, Gretchen, "Don't Be Sold the Wrong Life Insurance," *Worth* (April, 1994), p. 37: "It's a given that consumers can't count on getting the unvarnished truth from the roughly 250,000 insurance salesmen who make their livings on commission." *See also* Katt, Peter C., "A Perfectly Rational World," *Journal of Financial Planning* (October, 1994), p. 51: "…agents' performance standards focus on the amount of premium generated, not on the quality of purchase recommendations, accurate policy analysis, or servicing." For a brief history of the public's view of the life insurance agent profession, see Logue, Kyle D., "The Current Life Insurance Crisis: How The Law Should Respond," *Cumberland Law Review* (2001), pp. 33-34.

[13] For a lucid discussion of agent replacement activities, see Hunt, James H., "Technical Aspects in Evaluating Cash Value Life Insurance Policies," *Financial Planning Association of Greater Hudson Valley* (September 28, 2001), pp. 4-5 at jameshunt@cs.com. *See also* Mehr, Robert I. and Gustavson, Sandra G., *Life Insurance Theory and Practice* Fourth Edition (Business Publications, 1987), p. 130: "…all too often the agent pushes one particular type of policy and represents only one insurer, a practice that may result in suboptimal decisions."

[14] As one commentator writes: "Life insurance salespeople who use data supplied by their home offices to compare two or more companies do a disservice to consumers because they aren't trained to know what this data means. They make claims supporting their company or against a competitor that often are inaccurate or irrelevant. You should ignore comparative data selectively patched together by a competing salesperson to make a partisan point." Katt, Peter C., "Repainting an Old Canvas," *Journal of Financial Planning* (October, 1996), p. 28.

> company with a 9 percent ratio was a stronger company than one with a 7 percent ratio. That was because there was a great deal more homogeneity between the risk profiles of companies at that time…. now a company with a 9 percent ratio might actually be a lot weaker than a company with a 7 percent ratio….[15]

Thus, it is difficult to see how collecting unadjusted information, taken at its face value, provided by a sales agent or commission-based financial planner, satisfies the care, skill, and caution standards of Restatement Third.[16] Although commission-based agents or financial planners are a legitimate and important source of information regarding insurance policy rates and benefit provisions, it is the trustee that may be ultimately responsible for developing an objective and defensible criterion for carrier selection and policy design. Documenting prudence is something more than soliciting several bids in the form of biased sales presentations. Indeed, an important challenge for trustees is to implement reasonable procedures and safeguards so that they can develop productive relationships with life insurance agents and financial planners.

§2.4 DUE CARE ADVICE REGARDING SELECTION OF THE INSURANCE CARRIER

A prevalent theme in insurance advice literature is that trustees should seek to find the best company, or the best policy, or the best price. This type of treasure-hunting approach to asset management stands in stark contrast to modern principles of prudent portfolio management. During periods of insurance industry volatility, the advice literature focuses on how to select the safest company; during periods of lower industry volatility, the literature directs the trustee to seek companies with insurance products yielding the highest returns.

Following the demise of Executive Life, Mutual Benefit Life and a host of smaller carriers in the late 1980s and early 1990s, warnings went out to insurance buyers to pay strict attention to a carrier's financial condition lest a financial collapse result in a loss consisting of policy benefits. It stands to reason that a trustee would want to purchase life insurance coverage from a company that receives high ratings from the independent carrier evaluation services. In addition to the assigned ratings, however, the due care process often encompasses analysis of financial statement data. Areas of interest include corporate surplus, asset quality, liquidity, corporate earnings, leverage, and so forth. Agent-delivered due care analysis attempts to:

- Discover how a carrier's financial statement information compares to its competitors or to insurance industry norms; and,
- Spot trends in critical accounting data or actuarial performance measures that could materially influence a carrier's long-term earnings and profits.

Currently, several data vendors offer trustees prepackaged information extracted from annual reports, (convention blank) filings with state insurance commissioners, as well as from public filings with the Securities and Exchange Commission. The vendors organize and present publicly available information on financial performance measures and on accounting ratios of interest. The critical assumption is that access to unadjusted accounting information improves the quality and accuracy of the due care process, which, in turn, improves the forecasting accuracy underlying the

---

[15] Lennon, Terence, "Objectives and Expected Impact of Risk-Based Capital Requirements for Life Insurance Companies," *The Financial Dynamics of The Insurance Industry,* Eds. E.I. Altman ands I.T. Vanderhoof, Irwin Professional Publishing (New York University, 1995), pp. 18-19. Firm vulnerability to interest rate shocks is a function not only of the ratio of capital to assets but also a function of duration mismatching of assets to liabilities. Many insurance firms are vulnerable to financial risks (*e.g.,* viable competitive business strategies) that cannot be evaluated via traditional ratio analysis.

[16] Presentation of unadjusted data and accounting measures that lack comparability distorts the decision-making process. For example, a measure such as return on equity of a stock insurance company is not comparable to that of a mutual insurer. The denominator for many standard accounting ratios varies wildly for a company that has a history of merger and acquisition activity (goodwill may be a large intangible asset and may be valued as a financial statement balancing item rather than as a reflection of underlying value) as opposed to carriers without a M&A history. Some insurance carriers may have good liquidity while their holding companies may have poor liquidity. Reinsurance treaties can shift capital and liabilities either on an aggregate basis or on a piecemeal basis; and, such treaties may be used to improve ratios as opposed to adding economic value to the firm. The existence of many financial covenants and reinsurance arrangements are subject to rating triggers, and accounting measures that do not adjust for the effects of reinsurance are largely without value. Atkinson, David B., and Dallas, James W., *Life Insurance Products and Finance* (Society of Actuaries, 2000), pp. 878-882; Bazer, Laura and Abusch, Marc, "Update: Rating Triggers in the U.S. Life Insurance Industry in 2004," *Moody's Investors Service* (July, 2004). Agents untrained in financial analysis may refer trustees to "financially strong" carriers, when, in fact, they have merely identified a set of companies with excess capital resulting from an inability to deploy resources optimally (a competitive disadvantage) or with an inability to find profitable new projects (a sign of future company decline). Accounting measures have, primarily, contextual significance not absolute meaning.

trustee's choice of carrier and policy form. However, the art and science of financial prediction is challenging even for the trained analyst. Generally, the analyst must restate publicly available information because, over time, companies modify their accounting and reporting conventions for depreciation, inventory accounting, mergers and acquisitions, pension liabilities, etc.; and, it is highly unlikely that accounting measures reported by any two companies reflect the use of similar calculation methods and reporting elections.

The task of comparative financial analysis for insurers is made even more challenging because of the use of Statutory Accounting Principles (SAP) conventions that are insurance industry specific as opposed to the more commonly used Generally Accepted Accounting Principles (GAAP). It is the task of the financial analyst to adjust the financial statement information to make sure that the data under evaluation are cross-sectionally comparable and serially consistent. Failure to perform this task makes trend analysis or company comparisons meaningless. Indeed, extracting unadjusted information and using it to communicate conclusions to the public regarding a firm's earnings prospects or its financial soundness would ordinarily constitute malpractice under the standards promulgated by the CFA Institute. The insurance agent, however, may not be trained to communicate to the ILIT trustee anything more than unadjusted data culled from public sources and arranged in boilerplate formats. Although many commercial trustees expend considerable time and resources investigating publicly traded securities, when it comes to insurance policies, they may rely merely on information provided by individuals untrained in the formal analysis of corporate financials prepared under SAP accounting conventions, or may rely on boilerplate presentations of unadjusted data provided by outside service vendors. Such information is the starting point for due diligence, not the ending point.

To illustrate the problem, we note that an examination of a firm's statutory (SAP) profit contemporaneously with its GAAP profit can lead to opposite conclusions regarding its financial health. Insurance companies may attempt to maximize statutory profit because this is the most common source of information used to evaluate the carrier's financial condition. However, because new product sales require the creation of a reserve liability, a strong demand for a carrier's insurance products may strain its statutory surplus. The resulting lower statutory surplus is a basis for predicting the future vulnerability of the company to adverse experience and thus for a negative assessment of its future solvency prospects. GAAP reserve liabilities are calculated not on a statutory basis but rather according to an actuary's estimates. Because GAAP conventions match future expected profitability to the current activities that create this profitability, GAAP profits may be high during the period when the firm adds a significant amount of new business. The untrained observer may conclude that regulatory action is about to be triggered by a crisis in statutory profitability at the very time when GAAP profits indicate a company's overall financial success. Indeed, "…GAAP profits are often considered a better indicator of a company's overall well-being than statutory profits."[17]

§2.4.1 Back Testing Due Care Advice

Additionally, the prescribed methods of carrier due care analysis seem never to have been rigorously back tested. When a financial analyst develops a set of investment criteria based on examination of past stock or bond market movements, the first order of business is to back test them to see how well they would have worked under previous market conditions. Such a test (preferably on out-of-sample data) is no guarantee that the method will work under future market conditions; but, at a minimum, if a rule is designed to keep you from making a mistake it is a good idea to test it prior to recommending its use.

If we apply the current due care advice standards, constructed with the benefit of hindsight gleaned from the turbulence in the insurance industry during the past twenty-five years, it is difficult to see how there is any substantial improvement in the decision-making process. Consider, for example, the following data on Executive Life of California:

- Executive Life, by 1987 was one of the top insurance carriers. It received ten consecutive years of the highest rating by the A. M. Best Company.[18] In 1988, Moody's raised Executive Life's rating from A3 to A1. In 1988 *Fortune* magazine ranked Executive Life in the top fifteen U.S. life insurance companies in

[17] Easton, Albert E. & Harris, Timothy F., *Actuarial Aspects of Individual Life Insurance and Annuity Contracts,* ACTEC Publications (Winstead, CT, 1999) pp. 46-47. For a comprehensive discussion of the phenomenon of "new business strain," see Atkinson and Dallas *supra,* at 316-317: "Because of new business strain, an insurance company can actually become insolvent by writing too much profitable business." Atkinson and Dallas, at page 76, also discuss the reverse phenomenon known as "harvesting." This occurs when an insurance carrier attempts to maximize profit at the expense of failing to protect its long-term competitive position. Harvesting may create favorable interim financial results as the carrier executes its exit strategies, but it is unlikely that the company will remain a viable entity in the marketplace.

[18] Belth, Joseph M., "A List of Life insurance Companies with Ten Consecutive Years of Top Ratings from the A.M. Best Company," *The Insurance Forum* (November, 1987).

terms of total assets and ranked it third in terms of its profitability. Throughout 1989, Executive Life also maintained the highest (AAA) rating from Standard & Poor's.

- Throughout 1989, independent commentators offered endorsements of the insurance company. For example, Bruce A. Bunner, California Insurance Commissioner from 1983 through 1986 states: "Clearly, high-yield bond investments are appropriate for a prudently managed investment portfolio of a life insurer." F. S. Townsend, actuary and partner in the prestigious Townsend Schupp Company (a Hartford, Connecticut based company that analyzes insurance carriers) states: "First Executive was in the right place at the right time, and management had the foresight to capitalize on opportunities."[19]
- In 1989 Executive Life's average policy size ($300,000) was the largest in the U.S. insurance industry. At that time, the industry average policy size was below $50,000.
- The *Forbes Annual Report on American Industry* ranked Executive Life as number one among all U.S. life and health insurance companies for its 1988 profits per employee. Additionally, it ranked Executive Life number three for five-year return on equity.
- Executive Life's adjusted statutory net worth (inclusive of mandatory securities valuation reserve) was 6.9% of total assets in 1989. This was better than eight of the top ten largest insurance carriers including Aetna, Metropolitan Life, John Hancock and Northwestern Mutual.

The above-listed information can now be evaluated against the currently recommended due care process. A good example of this process is found in "Due Care in Selecting Life Insurance Policies and Carriers" presented as part of the 1996 ALI-ABA conference on "Uses of Insurance in Estate and Tax Planning." The author recommends that, in addition to the letter and number ratings assigned by the independent evaluation companies, special attention should be devoted to:

- Surplus adequacy;
- Asset quality and liquidity;
- The history of and future prospects for stable earnings; and,
- Management quality.[20]

In each category Executive Life earns superior marks.[21] Furthermore, during the 1980s Executive Life was alone among major U.S. insurance carriers in advocating major reforms in the preparation of insurance company financial statements. For example, under SAP conventions, general account asset portfolios are carried at amortized cost rather than fair market value. Executive Life, however, voluntarily marked its portfolio to market value (a GAAP convention) and challenged other companies to do the same. Executive Life argued that this allows consumers to evaluate correctly a company's true financial condition. Executive Life's 1984 Annual Report remarks: "…Executive Life is the only company of the top 25 life insurance companies in the United States whose portfolio's value is above cost." In 1986, Executive Life's Annual Report states:

> For a number of years, we have been suggesting to the various state insurance departments the need for insurance companies to adopt the discipline of 'marking to the market'; stating the true current market value of their investment portfolio on a consistent and current basis. This reform would not be easy. Statutory accounting requires insurance companies to carry their portfolios at amortized cost. This has long shielded the true market value of insurance companies' portfolios, and forcing a mark to the market could reveal large unrealized losses in many portfolios that would be difficult to deal with.

This period also saw uncertainty in the real estate markets; and plunging real estate valuations contributed to the national Savings and Loan crises. To the consternation of other major life insurance firms, Executive Life alerted consumers to the fact that the large insurance companies are not immune from the

[19] Belth, Joseph M., "Executive Life and 'Broker World' Magazine," *The Insurance Forum* (February, 1989), pp. 8-9.

[20] Turner, Catherine R., "Due Care in Selecting Life Insurance Policies and Carriers," *ALI-ABA Course of Study: Uses of Insurance in Estate and Tax Planning* (San Francisco, 1996), pp. 31-66.

[21] One cannot help but be struck by the strong similarities between the fall of Executive Life and the collapse of Enron together with its accounting firm Arthur Andersen in 2001. *Fortune* magazine named Enron the "most innovative company" for six consecutive years; in 2000, *Worth* magazine named Jeff Skilling as the second best CEO in America; in 1999, *CFO* magazine gave Andy Fastow the CFO Excellence Award; and, in 2000, *CEO* magazine named Enron's board of directors as one of the top five in America. *Financial Engineering News* (September/October, 2005), p. 3.

economic forces at work within capital markets. Indeed, an independent study of the collapse of Executive Life estimates that:

> All the top ten life insurers had very large investments in mortgages and real estate, ranging from 252% to 1,026% of statutory net worth. For half the top ten firms, mortgages and real estate exceed 700% of net worth, which is comparable to [Executive Life's] junk bond exposure at year-end 1989 and not that different from [Executive Life's] 1990 exposure…. Only a small percentage reduction in the statutory carrying value of mortgages and real estate would place all the top ten life insurers (except possibly New York Life) in the same statutory net worth position that [Executive Life] faced at year-end 1990, just before regulators took control in April 1991.[22]

The study suggests that most major insurance carriers rode out the storm in capital markets in the early 1990s because their accounting practices allowed them to obfuscate the true condition of their surplus (net worth). Executive Life, on the other hand, was the only major firm offering enough transparency so that the public could reach an informed decision regarding its financial condition. The study concludes that Executive Life's accounting statement transparency, combined with an extensive public relations campaign orchestrated by the allegedly conservative and safe blue-chip carriers, led to the run on the bank that ultimately destroyed Executive Life.

Regardless of the ultimate reasons for its failure (it should be remembered that Executive Life's corporate officers were allegedly misleading regulators regarding the status of its reinsurance treaties),[23] the important point is that even a retroactive application of today's due care standards may not have persuaded trustees to avoid Executive Life during the 1980s. The benefit of carrier due care standards is that they have forced, to a limited extent, insurance companies to make their operations less opaque. Regulatory pressures and market forces are driving many industry reforms; and, as insurers demutualized to access the equity markets, investors demand financial statements prepared under GAAP conventions, as well as additional disclosure of relevant financial and operational data.[24]

§2.4.2 Rationale for Due Care: A Critical Examination

Developers, promoters and vendors of insurance company due care systems have a heavy burden of proof. The claim, according to the ABA's *Life Insurance Counselor,* is that "failure to perform due care increases the risks of (1) buying a product that does not meet the actual insurance need, (2) facing one or more unanticipated future premiums after the payments were expected to stop, or (3) actually losing

---

[22] DeAngelo, H., DeAngelo, L., and Gilson, S., "The Collapse of First Executive Corporation: Junk Bonds, Adverse Publicity, and the 'Run on the Bank' Phenomenon," *Journal of Financial Economics,* vol. 36 (1994), p. 310.

[23] Belth, Joseph M., "Executive Life's Bermuda Reinsurance," *The Insurance Forum* (November, 1986), pp. 137-138.

[24] Easton and Harris, *supra,* at 130-132. A number of statements of the Financial Accounting Standards Board (FASB) now regulate life insurance GAAP accounting standards. Mutual companies have an exemption from several of these standards (SFAS 60, 97 and 113). Upon release of FASB interpretation 40 in 1993, however, mutual companies no longer had an exemption from SFAS 12 (Accounting for Certain Marketable Securities). SFAS 115, which creates three classifications for debt and equity securities, supersedes SFAS 12. SFAS 115 creates rules for reporting the fair market value of securities and for the reporting of both realized and unrealized gains and losses. The three classes are:

1. Held to Maturity
2. Available for Sale
3. Trading

With respect to debt instruments, management is permitted to report Held to Maturity assets at amortized cost. Assets in other categories must be reported at fair market value; but unrealized gains and losses are recorded as adjustments against either equity (if Available for Sale) or income (if Trading). Thus SFAS 115 allows asset values to be reported according to management "intent."

A survey of insurance company chief financial officers in 1997 for year end 1996 reveals that most companies held a larger proportion of assets in the Available for Sale category while only a small fraction were held in the Trading category. The median value of assets in the Held to Maturity category was 37 percent. It is interesting to note that "the held-to-maturity account was populated by private placements (35 percent), public bonds (28.5) percent, and mortgage-backed securities (24.5 percent). Although mortgages and real estate are not formally included in asset types covered by FAS 115, some ten companies reported that these assets represented 32.6 percent and 3.4 percent, respectively, of held-to-maturity assets. Cabanilla, Nathaniel B. and Brodie, Nancy S., "Survey of Chief Financial Officers on Company Practices," *Journal of Financial Service Professionals* (March, 1999) pp. 76-86. This can be contrasted to the available-for-sale account in which "private placements accounted for 9.5 percent. Mortgages and real estate represented 8.7 percent and 1.2 percent respectively." It thus appears as if a relatively large segment of assets that are not publicly traded are in Held to Maturity accounts. Although many of these assets may be rated highly by debt evaluation services, the marketability covenants surrounding these assets may restrict their liquidity. It remains difficult to form judgments regarding the financial stability of insurance carriers based on a simple survey of the types of assets that they own.

value through the life insurance carrier's insolvency."[25] Further, it advances the proposition that the "due care process is an ongoing effort. It begins with the selection of policies to be purchased. It continues while the policies remain inforce, with periodic reviews of current status and reprojection of policy results."[26]

It is worth spending a few moments on these claims because they form the rationale for much of the ongoing asset management activities of ILIT trustees. Having advanced the first rationale for a due care system, the *Life Insurance Counselor* quickly backs away from it: "Due care in this text does not address the appropriateness of the insurance marketing application for the specific need of the insured. The specific amount of insurance needed, and how the policy's ownership and funding are configured to meet a particular insuring need, are in the due care domain of the client and his or her advisors."[27] In other words, due care in this context is not really a due care analysis system so much as it is a careful consideration of whether insurance is needed in the first place; and, if yes, how much and what kind.

The second rationale for due care focuses on the initial credibility of the policy illustration and on the ongoing monitoring of the specific insurance product(s) owned by the trust. This is *policy* due care as opposed to *carrier* due care. There is, at best, only a tenuous relationship between carrier profitability and the performance of specific policy forms. Indeed, financial theory as well as some market research suggests that there may be an inverse relationship between a carrier's financial condition and the policy values it must offer to attract and retain policyholders.[28]

The third rationale focuses on the need to protect the trust against loss of value because of a carrier default. Both state regulators and insurance company analysts are interested in developing and implementing systems that exhibit predictive ability with enough lead-time to take remedial action. Unfortunately, no system has yet proved successful on a consistent basis. There are several underlying difficulties with current solvency monitoring and prediction models:

1. Disagreement regarding relevant variables: "…while these models are reasonably successful in identifying distressed firms, the models often suffer from 'statistical overfitting' and a lack of consistency over time with respect to the set of important variables related to bankruptcy."[29]
2. Insurance companies can decline rapidly, and significant differences between solvent and insolvent companies begin to appear only a short time (no longer than one year) before actual insolvency;[30] and,
3. The relevance of past data is questionable given the constant and rapid shifts in the legal, tax, economic, and competitive environments in which the insurance industry operates.[31]

The sudden, and more recent, defaults at Confederation Life of Canada and General American Life provide some proof that high ratings from independent evaluation services may have little predictive value. More to the point, some research indicates that the default rate among lower rated companies is not statistically different from the default rate among highly rated carriers.[32] This, of course, is not meant to be an argument for buying policies from poorly rated companies. Rather, it is meant to question the efficacy of launching extensive carrier due care analysis when there is little evidence that useful results will be forthcoming. The process of papering files with informa-

---

[25] *The Insurance Counselor, supra,* at 3.

[26] *Id.,* at 9.

[27] *Id.,* at 3. See, however, discussion of OTS regulations for savings associations at 49.

[27] For empirical tests of certain expectational hypotheses, see Carson, James M. and Forster, Mark D., "The Nature and Causes of Variation in Insurance Policy Yields: Whole Life and Universal Life," *Journal of Insurance Issues,* Vol. 23 (2000), pp. 30-47. The evaluation period for the study is 1988 through 1998.

[29] Carson, James M. and Hoyt, Robert E., "Identifying Life Insurer Financial Distress: Classification Models and Empirical Evidence," *The Financial Dynamics of the Insurance Industry* (Irwin Professional Publishing, 1995), p. 34.

[30] Klein, Robert W., "Solvency Monitoring of Insurance Companies: Regulators' Role and Future Direction," *The Financial Dynamics of the Insurance Industry* (Irwin Professional Publishing, 1995), p. 83.

[31] *Id.,* at 93. Among the current crises facing the insurance industry is the rise of a secondary market enabling certain insureds with health impairments to sell their policies to investors willing to continue making premium payments until the time of the insured's death. Prior to this option, the only liquidity option available to cash-strapped insureds not qualifying for benefits under terminal illness riders was to surrender the policy to the insurance carrier for a pre-specified value. Many insurance carriers claim that the existence of a secondary market makes it unlikely that they will realize projected economic benefits of policy surrenders. This, in turn, may mean that the insurance companies have mispriced the coverage and now risk insolvency if there is a substantial decrease in the policy surrender rate from the group of unhealthy insureds. *See,* for example, Doherty, Neil A., and Singer, Hal J., "The Benefits of A Secondary Market for Life Insurance Policies," *Working Paper, The Wharton School, University of Pennsylvania* (Modified 10/14/02).

[32] Ambrose, J., and Carroll, A., "Using Best's Ratings in Life Insurer Insolvency Prediction," *The Journal of Risk and Insurance,* Vol. 61, No. 2 (1994), p. 323.

tion of dubious value does not evidence use of care skill and caution; and, in the opinion of John Langbein, is mere "proceduralism."[33] As one insurance analyst states: "…an effective financial surveillance and regulation structure and system is needed. While everyone can agree that this is critical, to date no one has yet defined what constitutes an effective structure and system for financial surveillance and regulation."[34]

Although carrier due care systems, including software-based systems, provide reams of quantitative data, this information is often evaluated out of context.[35] It is worth reiterating that the letter and number grades assigned by rating companies are distillations from a comprehensive evaluation of the operations of the insurance carrier by trained analysts. There is little evidence that focusing on selected aspects of the rating company's narrative report or accompanying financial and operational exhibits will yield useful insights that would materially change a prudent investor's judgment regarding the analyst's overall opinion on the insurer's financial strength or claims-paying ability.

§2.4.3 Do Safe Assets Make For A Safe Company?

Focusing piecemeal on selected accounting information (often extracted from the rating company's report and distilled by insurance agents with a transaction agenda) may lead ILIT trustees to make spurious conclusions. Some analytical methodologies used by the due care systems are poor fits with the modern portfolio theory underpinnings of the Restatement Third. According to modern portfolio theory, the basic unit of analysis is the portfolio as a whole rather than the individual investments from which the portfolio is built. A company with a portfolio built entirely from government guaranteed bonds, for example, may have a low risk rating in some due care systems despite the fact that it might be vulnerable to unanticipated interest rate movements. The reader may recall that Orange County, California was driven into bankruptcy while managing a portfolio backed primarily by U.S. government bond obligations. Looking at the individual assets, the portfolio appears to be safe; looking at the portfolio structure reveals the opposite.

A carrier's financial position can, in part, be measured by an analysis of the liquidity of its assets (can it unwind positions in assets should their value start to erode), and the variability of its surplus (will changes in the value of assets and liabilities suddenly create a crisis with respect to the adequacy of a firm's surplus). The risk to surplus is a key measure of financial vulnerability and depends on a variety of critical determinates including the firm's asset/liability matching strategies. Every sale of an insurance policy represents an added liability. Each new liability requires a reserve; and, to maintain financial solvency, assets with a market value sufficient to discharge the liability must back the reserve. Thus, insurance company solvency is a function not of its assets or of its liabilities; but, rather, of the dynamic interrelationship between them. This makes reliance on accounting ratios or asset categorizations wholly inadequate measures of an insurance carrier's financial health:

> In an economic sense, we need not focus on accounting concepts such as reserves, surplus, and risk-based capital. From a managerial viewpoint, these are best viewed as merely regulatory constraints. What is needed to cushion the liabilities against inadequate assets is actual money, as measured by the net tangible value—the excess market value of tangible assets over the present value of liabilities…. The present value of an insurance liability is not dependent on what assets the insurer holds nor on how its portfolio is structured. Rather, it depends simply on how much in default-free securities would be required today to meet its expected liability payments over time. Again, the present value must account for any interest rate sensitivities in the liabilities.[36]

[33] "Proceduralism is a common retreat in fields in which substantive law provides inadequate guidance…" Langbein, John H., "The Uniform Prudent Investor Act and the Future of Trust Investing," *Iowa Law Review,* Vol. 81 (1996), p. 662. The reporter for Restatement Third argues, in a similar vein: "The standard of prudence in the trust law, however, should not be without substantive content and principles by which to judge and guide a fiduciary's conduct. That is, the law should call for more than a paper trail." Halbach, Edward C., "Trust Investment Law in the Third Restatement," *The Uniform Principal and Income Act and the Prudent Investor Rule* (California Continuing Education of the Bar, January 2000), p. 111.

[34] Rich, Sanford, "NAIC Solvency Agenda: An Overview," *The Financial Dynamics of the Insurance Industry* (Irwin Professional Publishing, 1995), p. 6.

[35] Turner, Catherine R., "Evolution Of The Life Insurance Industry," *American Bar Association Annual Meeting, Real Property, Probate and Trust Law Section* (August, 1994), p. 5: "'Spreadsheeting' on the basis of company financial statistics is often a common part of today's sales proposals. Valuable information may be provided in this way, but financial ratios presented on an inconsistent or incomplete basis can be as misleading as current illustrations."

[36] Babbel, David F. and Merrill, Craig, "Toward A Unified Valuation Model for Life Insurers," *Changes in the Life Insurance Industry: Efficiency, Technology and Risk Management,* Second Edition (Kluwer Academic Publishers, 2002), pp. 261-263.

This is a very different solvency evaluation process than found in most traditional due care advice literature. Traditional due care encourages the ILIT trustee to focus primarily on selected actuarial measures (projections of lapses and mortality experience) as well as on earnings on assets (the presumption being that a firm that earns a yield on invested assets higher than that credited to policyholders is financially sound). The risk of a significant mismatch between assets and liabilities (or, equivalently, the risk of insufficient surplus) depends not only on the structure of state-contingent liability payments for deaths and surrenders, and not only on yields on invested assets, but, primarily, on the stochastic evolution of interest rates, path-dependent cash flows, and embedded options within the asset portfolio (*e.g.,* option to prepay mortgage obligations, extension and contraction risks of debt instruments, etc.). To a great extent, the Savings and Loan crisis occurred not because the lending institutions had bad or unsafe assets (residential mortgage loans); but rather because of a mismatch between the duration of assets (loans) and liabilities (obligations to depositors). This is one of several risks inherent in the insurance industry for which public information is simply not available.

The safety of insurance company portfolios can best be judged from within the "portfolio context" that underlies modern portfolio theory. This is more than a simple parsing of the insurer's assets. As noted, policy reserves are liability accounts the values of which are based on actuarial estimates of the present value of funds necessary to discharge the future obligations of the life insurance contracts under fixed and conservative assumptions. The key term in this sentence is "liability." Unlike a common use of the term reserve (*e.g.,* I have a cash reserve against unforeseen emergencies) that suggests that a reserve is an asset, the opposite is true for insurance company reserves. Reserves are merely accounting constructs that are entered on the liability side of insurance company financials.[37] A company is solvent only when asset values balance the reserve liabilities. Classifying individual assets as "safe" or "speculative" gives little indication of whether the assets' market values match up well with the reserve liabilities.[38]

Although statutory solvency requires that the cash

[37] Just to make things confusing, certain policy acquisition costs are capitalized and put on the asset side of the Balance Sheet.

[38] A publicly traded insurance company will cease to be a viable firm under two general conditions: (1) it fails to earn sufficient profits to compensate shareholders; or, (2) it fails to maintain asset values sufficient to discharge its liabilities to policyholders. The first condition is also of concern to policyholders because the carrier may seek attention as a merger or acquisition candidate by boosting short-term profitability at policyholder expense. This is a classic "agency problem" between owners and policyholders. But the failure to earn sufficient profits may be a result of poor business strategies, regulatory rulings that change the nature of a firm's market, unforeseen competition from other financial product and service providers, or a host of other circumstances that cannot be captured in actuarial performance data. Regulators protect the interests of policyholders and the public primarily by monitoring the second set of conditions; and receivership is the end result of a failure to maintain statutory solvency. The policyholder's interest, however, is compromised by company failure under either set of circumstances.

This is also why variable life products using separate accounts are not necessarily the panacea that some of their promoters claim. Variable products not only shift risk from the carrier to the policyowner, they increase total risk—*i.e.,* risk to policyowner and to insurance carrier. The ILIT now bears the risk of inadequate investment performance; but the carrier's financial results also become more sensitive to market conditions because profit margins are functions of asset-based fees. Declines in separate account values may drive revenues downward and increase the likelihood that the carrier cannot generate sufficient earnings to make this administratively expensive block of business profitable. *See* Panko, Ron, "Taking a Punch," *Best's Review* (March, 2003) pp. 65-70.

Additionally, with the introduction of new and more complex insurance products, economic viability of insurance carriers becomes more uncertain. Paradoxically, some new non-variable products also create greater risk for the policyholder as well. The payoff of a life insurance policy is dependent on the performance of an underlying portfolio of assets; and, the insurance policy may be considered a derivative security with all of the attendant risks of options, futures and other financially engineered products. Thus, many new products (often used for replacement of older policies) do not merely shift or reallocate risk, but represent an increase in total risk both to the insurance carrier and to the policyholder. Risk is increased for the manufacturer because it is often the case that reserve liabilities must be hedged through use of complex financial products that are replete with optionality.

From the perspective of the policyholder (or regulator) concerned with type two conditions, the mathematics of insurance company solvency is of interest. In order to maintain solvency, the insurance company must maintain a surplus (market value of assets exceeds market value of liabilities). Risk management and monitoring activities that focus on limiting the variability of surplus subject to the constraint that surplus must always be positive are of paramount importance. But surplus variability is a function of (at least) four variables even assuming that actuarial assumptions (distribution of actual lapse and mortality experience matches distribution projected at time of issue) are completely accurate:

1. Surplus asset selection: The ability to forecast the returns of assets in the surplus investment portfolio;

2. Credit risk: The ability to forecast the credit risk spreads and default risks in the portfolio of assets backing the company's liabilities;

3. Maturity mismatch: The ability to forecast the future term structure of interest rates (duration and convexity sensitivities); and,

4. Funding mismatch: The ability to forecast the relative performance of assets matches against liabilities with assets in the surplus portfolio.

The reader can note that traditional insurance carrier due care activities focus primarily on the second term and, therefore, may flows from assets match the demand for cash created by the liabilities, cash flow matching is appropriate only if premium inflows are certain. With the advent of flexible premium products, asset-liability matching becomes more complex. An actuary can arrive at different conclusions regarding valuations depending upon which stochastic valuation methodology he chooses to use.[39] This explains why even the newer risk-based capital (RBC) standards adopted by the National Association of Insurance Commissioners in December of 1992 are not a good yardstick for generating predictive measures of the strength or safety of insurance carriers: "…the RBC formula emphasizes asset risk. Thus a company with only high-rated bonds and no mortgage investments may have a…high ratio. Yet the company's business strategy may be a risky one that could wipe out the company's capital quickly. Such a risky strategy may not be reflected in the RBC formula…. There is a poor relationship between RBC ratios and financial ratings."[40] An emerging concern is that insurance companies are managing their assets to appear in the best light with respect to risk-based capital ratios so that the company can secure high ratings from the independent evaluators and can project the image of safety and security to the public. The portfolio management strategies required to accomplish these objectives may, however, be suboptimal in terms of optimizing for the earnings and profits necessary for the company's future economic viability.

§2.4.4 Predicting Company Solvency

Another major risk to future financial solvency is product or actuarial pricing inadequacy, which can only be determined by looking at a company's asset share statements. Asset share statements are the actuarial models used by the insurance carrier to price its products. But this is proprietary information and extremely difficult to obtain.[41] However, without the ability to obtain and evaluate this critical information, any due care analysis system merely tilts at windmills.

The Society of Actuaries defines four risk factors faced by insurance companies:[42]

- C-1 risk is the risk of decreases in asset values because of adverse general market conditions, or a default by a borrower of insurance company funds;
- C-2 risk is the risk that the insurance products are not adequately priced to cover mortality and other cost factors, or that the frequency and magnitude of claims does not conform to original distribution assumptions;
- C-3 risk is interest rate risk that exposes a carrier to insolvency due to a mismatch between the value of assets and liabilities; and,
- C-4 risk is general business risk that includes changes in tax law and industry regulation, litigation arising out of fraud, malfeasance, and market misconduct, product obsolescence, etc.

C-4 risk encompasses, to a great extent, unique risks that are intractable to long-term prediction. These risks include changes in tax laws, fraud, run-on-the-bank episodes, misallocation of assets, and so forth. Historically, many insurer insolvencies derive from C-4 type of risk.[43]

---

fail to consider most solvency risk factors. For a formal exposition of the mathematics underlying these concepts, see Plantinga, Auke and Huijgen, Carel, "Performance Measurement and Insurance Liabilities," *The Journal of Portfolio Management* (Spring, 2001), pp. 105-115. For a discussion of the risks of variable products, see Atkinson and Dallas, *supra,* at 106-107.

The reader may also note that the difficulties with undertaking a meaningful due care investigation of life insurance carriers rivals the difficulties in projecting the fiscal soundness of defined benefit pension plans merely by examination of publicly disclosed corporate financials. *See*, for example, Elton, Edwin J. and Gruber, Martin J., "Optimal investment strategies with investor liabilities," *Journal of Banking and Finance* (September, 1992), pp. 869-890; Ryan, Ronald J, and Fabozzi, Frank J., "Rethinking Pension Liabilities and Asset Allocation," *The Journal of Portfolio Management* (Summer, 2002), pp. 7-15; and, Sharpe, William F., "Budgeting and Monitoring Pension Fund Risk," *Financial Analysts Journal* (September/October, 2002), pp. 74-86. Corporate financial statements taken at face value did not indicate the magnitude of emerging funding deficits within the plans.

[39] Babbel, David F., "Asset-Liability Matching In the Life Insurance Industry," *The Financial Dynamics of the Insurance Industry* (Irwin Professional Publishing, 1995), pp. 239-255.

[40] Belth, Joseph M., "Risk-Based Capital," *The Insurance Forum* (August, 2000) p. 73.

[41] Easton and Harris, *supra* at 33: "Asset share formulas are often quite complex, since they must take into account (at a minimum) premiums, death benefits, surrender payments, investment income, dividends, taxes, and expenses of all kinds. Depending on the intended use, asset shares may also take into account other experience factors, such as policy loan usage. Arriving at appropriate assumptions, and formulas that reflect them can be a challenge to the actuary who is responsible for their determination."

[42] Babbel, David F. and Santomero, Anthony M., "Risk Management by Insurers: An Analysis of the Process," *Investment Management for Insurers* (Frank J. Fabozzi Associates, 1999), pp. 16-17.

[43] Black, K. and Skipper, H.D., *Life Insurance,* Twelfth Edition, Prentice Hall, New Jersey (1994), p. 296.

Insurance company risk assessment often considers only selected variables tractable to long-term prediction. Unfortunately, risk prediction models usually consider the variables in isolation rather than as dynamic factors operating in an environment characterized by complex and possibly non-linear interactivity. For example, financial strength ratios may be derived primarily from a univariate analysis of financial statement data. A company that demonstrates a five-year trend of increasing surplus seems to evidence financial strength. However, if surplus is increasing because declining sales mitigate the pressure of business acquisition costs, the trend may, in fact, evidence financial weakness. Only models capable of multivariate analysis can illuminate important interrelationships between financial variables. This type of high-level statistical model building has been largely confined to academic institutions,[44] although government regulators charged with protecting the public against carrier defaults have made significant advances both in solvency monitoring methodologies and in the effectiveness of regulatory oversight and enforcement structures.

Important advances in the area of solvency monitoring made by both regulatory agencies and independent insurance company evaluation agencies make it clear that most of the traditional advice flowing from the life insurance industry (*i.e.*, simplified methods of reviewing C-1 and C-2 type risks) may not be useful to trustees charged with the duty to manage insurance policy assets.[45] The history of attempts to develop solvency-monitoring models is a topic of some interest in that it also provides insights into how certain monitoring systems can be gamed by insurance carriers.

Historically, in environments characterized by low and stable interest rates and by fixed-income investment vehicles lacking complex optionality (unlike, *e.g.*, assets like Collateralized Mortgage Obligations with prepayment options that create future cash flow uncertainty), it sufficed for analysts to focus on credit risk monitoring. The process of risk management was primarily one of constant refinement in the ability to both monitor risks and to manage such risks to the insurance company's best advantage. With increases in (1) interest rate volatility; (2) the complexity of new investments placed on the asset side of the balance sheet; and, (3) the uncertainty of cash flows from new types of insurance policies placed on the liability (reserves) side of the balance sheet, the simplified credit risk and financial strength monitoring formulae that informed the due care advice of the early 1990s are no longer adequate. One response of both insurance regulatory agencies and of the independent rating companies was construction of Risk-Based Capital (RBC) ratios. The RBC ratio developed by the NAIC in the early 1990s has at least two objectives:

1. Supplement the minimum capitalization standards of individual states with a more suitable capital standard reflective of an insurer's actual operational risk and investment strategies; and,
2. Supplement traditional default risk monitoring criteria with a tool that better reflects the riskiness of insurer cash flows (from both investments and premiums) in a more volatile economic environment.

The RBC calculation requires an adjustment or "charge" for each type of investment risk reported in the insurance company's annual statement. The amount of the charge depends on formulae developed through statistical analysis of historical variances in various risk categories of investments. Investments guaranteed by the U.S. Treasury have a lower charge than stocks, real estate, mortgage indebtedness, and so forth. The carrier's actual total capital (adjusted for certain investment reserving factors) is divided by the RBC amount to determine the RBC ratio. Regulatory action is forthcoming for companies failing to meet certain minimum capital standards. Whereas the NAIC RBC ratio is used as an objective regulatory monitoring tool, independent rating agencies like Standard & Poor's and A.M. Best developed capital ratio formulae that incorporate both objective information as well as qualitative assessments of other risk factors. Interestingly, the rating agencies use the formulae to judge the relative financial strength of insurance carriers. This is a very different objective than the regulatory measurements; and, not surprisingly, may yield vastly different results. A rating agency may evaluate management and corporate business strategies, liquidity and operating efficiency, prospects for future growth and competitive

[44] *See*, for example, the "ratio correlation matrix" developed by Borde, S., Chamblis, K., and Madura, J., "Explaining Variation in Risk Across Insurance Companies," *Journal of Financial Services Research*, Vol. 8 (1994), p. 188.

[45] The following discussion of carrier solvency monitoring and evaluation draws, in great part, from the following articles: Pottier, Steven W. and Sommer, David W., "Life Insurer Risk-Based Capital Measures," *Journal of Insurance Regulation* (Winter, 1997), pp. 179-196; Grace, Martin, Harrington, Scott and Klein, Robert, "Identifying Troubled Life Insurers," *Journal of Insurance Regulation*, (Spring, 1998), pp. 249-290; Henebry, Kathleen L. and Diamond, Jeanette M., "Life Insurance Company Portfolio Composition and Investment Regulation," *Journal of Insurance*, Vol. 21 (1998), pp. 183-203; Klein, Robert W., "The Growing Sophistication of Solvency Policing Tools: From IRIS to Accreditation and Beyond," *Journal of Insurance Regulation* (Winter, 2000), pp. 235-258; and, Barth, Michael, "Risk-Based Capital: A Retrospective," *Journal of Insurance Regulation* (Winter, 2001), pp. 233-242.

strength relative to other carriers, conservatism in liability reserving, reinsurance arrangements, etc. Weaknesses in these areas can offset what might be high RBC ratios developed under the NAIC formulae; or, conversely, strengths in these areas might enhance what might otherwise be a low RBC ratio. Historically, there has been a low correlation between independent ratings and NAIC RBC ratios except in the very lowest of the rating categories.

NAIC RBC ratios do not convey much useful information in terms of carrier due care analysis. A carrier or a product selection or retention guideline based on a high RBC ratio is merely a formulaic exercise rather than evidence of a prudent decision making process. Additionally, there is a wealth of opportunities for an insurance carrier to bias the RBC ratio. On the asset side of the balance sheet, there is some evidence that insurance companies are decreasing investment exposures in areas with high RBC charges such as mortgages and stocks in favor of equally risky non-traditional investments that fall into the general category of "other" under the NAIC's classification system and for which the RBC charges are lower. On the liability side, there appears to be significant use of surplus notes not only among companies with low RBC ratios and higher default risk; but, more recently, among the major U.S. life insurance carriers. Just as there is a category of "non-admitted" assets (*e.g.*, the real estate value of a home office, the value of furniture, etc.), there is a category of "non-admitted" liabilities under statutory accounting principles. A surplus note is a debt obligation of an insurer that will not appear on the liability side of the balance sheet until or unless the insurer's surplus exceeds a level specified by the debt instrument.[46] Surplus notes allow a company to smooth the downside variance of its surplus (a positive surplus is a requirement for solvency) by placing assets on its financial statements without the need to book the corresponding liabilities.

Additional games are possible through the purchase of SEC Rule 144(a) private placements that are transactions between qualified institutional buyers. Qualified transactions in the insurance industry usually involve placements of corporate bond issues that, although exempt from registration and lacking the usual liquidity found in capital markets, carry ratings and RBC charges that are equivalent to comparable issues registered for secondary transactions. Although the illiquidity of private placements can wreak havoc in recessions, it is difficult to develop the evaluative criteria required for effective predictive financial modeling for firms that carry such issues in their investment portfolios. The recent defaults of private placements from firms like Enron and WorldCom, for example, triggered a significant downgrade in the financial ratings of the U.S. insurance industry.[47]

Concurrent with the implementation of a regulatory action system based on RBC ratios, significant advances were made with respect to improvements in detecting early warning signs of financial difficulties. Traditionally, a key regulatory monitoring tool was the system of performance measures and accounting ratios monitored by the Insurance Regulatory Information System (IRIS). However, the system seemed inadequate in terms of providing reliable indications of forthcoming carrier insolvency. The system was largely formulaic, based on data reported on annual statements filed with the states, gave many false positive indications, and failed to include variables that had important predictive value. In 1990, the Financial Analysis Solvency Tracking (FAST) system, designed to address some of the limitations, supplemented IRIS. Academic evidence indicates that, although the FAST system can identify companies in financial difficulty approximately one to three years prior to the onset of insolvency, models based solely on financial ratio analysis are reaching the point of diminishing returns. An endemic problem with the models currently in use is that the critical variables for past insolvencies may not have equal importance in the future. Past economic conditions are unlikely to repeat and certain financial ratios may be afforded weights that are not merit-

[46] Even at this point, only currently due interest and principal rather than the full obligation may be recognized. *See* Dumm, Randy E. and Hoyt, Robert E., "Surplus Note Utilization by Life Insurers: Empirical Evidence," *Journal of Insurance Regulation* (Spring, 1999), pp. 348-378; and Belth, Joseph M., "The Surplus Note Catastrophe at Lumbermens Mutual," *The Insurance Forum* (November, 2003), pp. 285-300.

[47] "Moody's Changes Rating Outlook for the U.S. Life Insurance Industry to Negative From Stable," *Moody's Investors Service* (September 6, 2002). This discussion suggests the difficulties faced by ILIT trustees attempting to document prudent asset management. The increasing sophistication of independent rating organizations such as Moody's makes the number/letter grading systems more credible. However, the grading is often done "on a curve." The high current rating assigned to an insurance company may simply indicate that the carrier is relatively better off than its industry competitors; however the high rating should not mask the fact that the industry as a whole may be in difficult economic straits. Purchase of an insurance policy, guaranteed investment contract or annuity from a highly rated company may simply be the economic equivalent of purchasing a "highly rated" junk bond. In July 2004, Moody's changed the outlook on the U.S. Life Insurance Industry to stable from negative. "Credit Issues and Trends for US Life Insurance," *Moody's Investors Service* (July, 2004). Of the 177 companies evaluated by Moody's, only 2% received a "positive outlook."

ed under newly emerging economic regimes. The regulatory system is based on retrospective examination of certain historical indicators of financial difficulty. This backward-looking focus largely ignores the financial risks inherent in the insurer's business and asset management strategies; as well as the probability and magnitude of exogenous economic shocks including unexpected interest rate volatility.

The new frontier in solvency monitoring incorporates both the traditional types of credit risk analysis as well as the formulaic "cash flow" risk and accounting ratio analysis of RBC ratios, IRIS and FAST. However, current models supplement this information with asset/liability matching analysis based on simulations of thousands of interest rate paths.[48] The primary concern is to assure that an insurance company capable of passing traditional regulatory tests will remain a viable economic entity that produces a positive net present value for its shareholders. Risk is primarily measured in terms of the variability of an insurer's true surplus. Statutory surplus, based on mandated static mortality and interest rate assumptions, is largely unaffected by changes in inflation or interest rates. Ultimately, however, statutory surplus must reflect any mismatches between assets and liabilities either via adjustments to reported earnings or, more directly, through increases and decreases in reserves. A company that is solvent under the conservative Statutory Accounting Principles may go out of business because it cannot provide sufficient return to its owners. Thus the distinction between true surplus—and the risk factors to which it is subject—and statutory surplus (book value of assets minus book value of liabilities) is critical. One study, using a simple duration measure, suggests that matching short-term liabilities with a long-term portfolio of Treasury Bonds could result in a ten percent decline in asset values based on only a one percent rise in interest rates.[49] If a company attempts to increase its competitive position by reaching for high yields on invested assets, it may incur significant risks that do not register on regulatory radarscopes. Whereas the surplus of many life insurers usually does not exceed 10% of legal reserves,[50] small changes in interest rates that magnify asset/liability valuation differentials can thrust a company that is, by all appearances and measures, financially sound, perilously close to financial ruin.

For many years the life insurance industry seemed to be an exception to the Schumpeterian definition of Capitalism as a process of creative destruction. The industry flourished in the 1950s and 1960s in a stable interest rate environment; the risk of business failure for reasons other than fraud or gross mismanagement was practically nonexistent; and profit margins were assured by pricing products on a spread or cost plus basis. Today, the picture is much different. The speed of competitive, economic, and regulatory regime change is far greater than ever imagined and the magnitude of the financial consequences flowing from these changes all but invalidates trustee asset management approaches designed to find the single best policy or the single best company based on track records compiled under past operating procedures and economic conditions. Track records generated under previous tax, regulatory, competitive, and economic regimes may be poor predictors of future success.[51] Benefits ultimately flow to policyowners from insurance carriers who will either flourish or decline depending on their competitive advantages among a wide range of financial institutions vying for the consumer's savings and protection dollars. The insurance industry faces business and financial risks that have profound consequences for its economic viability. Trustees can no

[48] Atkinson and Dallas, *supra* at 895: "Even when assets and liabilities are perfectly matched, there may still be interest rate risk, because of accounting quirks. This can happen when assets are marked to market value and liabilities are not. A substantial increase in interest rates could cause financially strong company to appear financially weak or even insolvent."

[49] Arnott, Robert D. and Flynn, David P., "Controlling Insurance Risk and Consumer Costs: Asset Risk under Risk Based Capital Requirements," *Journal of Insurance Regulation* (Fall, 1993), pp. 81-87. For a detailed history of attempts to model the economic viability of insurance firms based on asset and liability cash flows that evidence interest rate sensitivities as well as path dependencies, see Babbel, David F., "Asset/Liability Management for Insurers in the New Era: Focus on Value," *The Journal of Risk Finance* (Fall, 2001), pp. 9-17.

[50] Mehr and Gustavson, *supra* at 581.

[51] The sea-change in pricing for participating (dividend paying) insurance policies is nicely summarized by two actuaries: "Years ago, par premiums were typically based on the net premiums calculated for reserve purposes plus a margin for expenses. This meant premiums were based on the same conservative mortality and interest rates used for reserves. Dividends made up for the difference between actual mortality, interest, and expenses and those built into the premiums. Today, par premiums and dividend scales are more likely to be developed using pricing models. Pessimistic assumptions might be used to establish premiums that will be adequate under adverse conditions. The level and slope of the dividend scale are often part of the product design. In other words, dividends have become more than just a mechanism for returning excess earnings and ensuring equity among policyholders." Atkinson and Dallas, *supra* at 13-14. This commentary suggests the reason why it is difficult to predict future superior performance through examination of the historical track record. In the case of dividends, for example, the historical record reflects a strong interrelationship between dividends paid and the differential between reserve assumptions and actual experience. Current dividend projections, however, may have a stronger relationship to current marketing objectives dictated by competitive imperatives.

longer remain confident regarding the solvency of insurance carriers simply because they pass regulatory examinations and actuarial performance checklists. Policy performance and carrier solvency are, ultimately, a function of corporate business strategies and the competitive environment in which they are executed. The risks of conducing business in the insurance industry have increased substantially, and it is not at all apparent that the industry will be able to meet a myriad of new challenges.[52] Although the industry-recommended due care process for ascertaining carrier financial stability and product illustration credibility undoubtedly influences standards of practice for ILIT trustees, there is little evidence that the current due care methodologies actually yield useful results.

What then is the value of the traditional due care process with respect to carrier safety? It appears as if the primary value is that it provides something to put in the file to demonstrate the veneer of trustee procedural prudence. But if the primary value of creating an impressive looking paper trail is for liability protection, the process may be counterproductive.[53] Formal (or formulaic, pre-packaged commercial information programs) due care procedures undertaken by trustees with little or no background in modern portfolio theory, financial economics, or corporate financial analysis may not constitute a substantively prudent process.[54]

The wave of due-care advice literature emanating from the insurance industry is, in large measure, a reaction by marketing departments to the sales crises initially brought about by the failure of several large insurance companies, and subsequently, by the failure of insurance policies to perform as illustrated. Life insurance practitioners saw a way to transform their image from the insurance salesperson to the insurance counselor. Although, in general, lacking the background, training and skill sets required for a genuine metamorphosis, the sales agent appears to don the mantle of the financial analyst merely by presenting selected accounting information to his prospects. The agent becomes a counselor because he cautions buyers to avoid financially unsound carriers and to place all of their coverage in an excellent company. One is tempted to recall Will Roger's advice to investors: "Buy only good stocks that go up in value. If they don't go up, don't buy them." Trustees, concerned about the economic hardships inflicted upon policy owners in the event of company failure, quite correctly looked for legitimate methods to control insurance policy risk. The insurance industry had a compelling solution: use our agents/counselors to assist in due care analysis. The due care sales solution became the standard of practice for ILIT trustees. The difficulty is that it forces the ILIT trustee to represent that it can make financial and performance forecasts the accuracy of which are highly uncertain.

§2.5 DUE CARE ADVICE REGARDING SELECTION OF THE INSURANCE POLICY

Insurance policy due care is a process intended to enable the trustee to make informed decisions regarding the likely future performance of the trust-owned insurance program. *The Insurance Counselor* defines insurance policy due care for initial policy selection as "setting reasonable expectations for the range of results that may develop at the time a policy is purchased." The text observes:

> Due care also continues after issue. As actual experience emerges, premium payments may need to be adjusted, or additional coverage applied for, to continue to meet the original objectives.... Sensitivity to experience

[52] *See* Schott, Francis H., "Toward Financial Services: Life Insurance at the Turn of the Millennium," *Journal of Financial Service Professionals* (November, 2000), pp. 80-85, for a good review of the competitive challenges facing the industry. Schott notes "safety and competitiveness clash in the world of expanding financial service providers."

[53] Maloney, Eugene F., "The Investment Process Required by the Uniform Prudent Investor Act," *Journal of Financial Planning* (November, 1999), p. 84: "A paper trail will be of little value unless it reflects an understanding and consideration of risk in accordance with the basic tenets of modern portfolio theory."

[54] A series of recently court decisions in New York have been especially critical of defenses based on "proceduralism." The court, in the *Matter of the Estate of Janes*, 630 N.Y.S.2d 472 at 477, rejected a defense that offered evidence of yearly meetings to review the trust portfolio: "To assert that mere review, analysis, and monitoring satisfies the standard of due care by a prudent person where action and activity are indicated, tests the Court's sense of reason and logic and more importantly flies in the face of the surcharge cases heretofore cited." The New York Surrogate Court [Testamentary Trust UW Dumont, 2004 WL 1468746 (June 25, 2004)] determined that the annual asset review "was little more than a reason for the trust officers to pick up the file, and possibly to communicate to each other in order to generate paperwork for an amalgamation of superiors to almost blindly sign their approval." One commentator, upon reviewing these decisions, concludes: "Having a record of annual Regulation 9 reviews is not sufficient to save a trustee from a claim of failure to follow procedures, when the content of the review is not spelled out in detail and where the failure to act indicates that this was a mere formality rather than an incisive and prudent analysis." Campisi, Dominic J., "Litigation Update," *ALI-ABA Course of Study Representing Estate and Trust Beneficiaries and Fiduciaries* (San Francisco, California, July 21-22, 2005).

> changes varies widely depending on product structure and funding choices. The same is true of the post-issue alternatives for managing those effects.[55]

Although there is some agreement among commentators regarding the information required to monitor an existing life insurance policy, there is little agreement on how to evaluate the likelihood that a policy will remain a prudent investment both in terms of the probability of actual values matching the values projected at the time of policy issue, and in terms of the ongoing suitability of the investment to the purposes, terms, distribution requirements and other circumstances of the trust. The former is an issue of illustration credibility while the latter is an issue of replacement or surrender suitability.[56] Probably the best statement ever written on insurance policy due care comes from insurance consultant Glenn Daily:

> There is no simple way to compare or analyze life insurance policies. If there were, fee-only consultants would have written a short article explaining how to do it and then moved on to other occupations. You can certainly find charlatans who claim to have a simple method, but you will find no support for these claims in the voluminous academic literature on this subject. Therefore, fiduciaries who use these methods will have some explaining to do if they are ever invited to appear in court.[57]

A review of ILIT advice literature indicates that suggested standards for policy evaluation (due care) proceed along several dimensions:

1) Examination of carrier financial and operational data with the objective of extrapolating company performance to policy performance;[58]
2) Quantitative rate of return analysis;[59] or,
3) Examination and testing of policy illustrations (either sales illustrations for new insurance or in-force illustrations for existing insurance) to determine the plausibility of projected values.[60]

Although the above-listed standards are not mutually exclusive, for clarity of exposition we consider each policy due care method in turn.

§2.5.1 Linking Carrier Financial Data to Individual Policy Performance Predictions

It is tempting to extrapolate a carrier's success in meeting its earnings and profit objectives to policyholder success in meeting policy benefit projections. Consider, for example, the following advice:

> …high ratings are not the be all and end all of determining that a carrier is a proper steward of the client's money…. Read the reports, looking beyond the carrier's ability to cover a claim. Talk with the agents about how the carrier is doing in the critical areas of mortality experience, investment management and expense control. Look at trends in distribution, growth and profitability from all lines of business…. Try to glean from the reports a sense for whether the carrier is well positioned

[55] *The Insurance Counselor, supra* at 145. Note, also, that the observation implies that the trustee is responsible for determining the adequacy of coverage relative to the economic objectives of the settlor. Many ILIT trustees administer the trust portfolio based on premium gifting constraints rather than on a periodic analysis of the amounts of insurance necessary to achieve grantor objectives. For example, if a settlor's objective is to provide funds for business succession or continuation purposes, is the trustee responsible for a failure to conduct a yearly business appraisal, for a failure to recommend purchase of additional coverage to match the company's growth rate, for failure to elect to surrender a cash value policy for a term policy providing a higher death benefit?

[56] The issue of how the trustee determines the prudence of policy replacement is outside the scope of this article. See, however, Collins and Jurkat *supra.*

[57] Daily, Glenn S., "Danger: Fiduciary Liability Ahead," http://www.glenndaily.com/fiduciaries.htm, p. 5. The lack of comparability between insurance products is a pervasive theme in the academic literature. *See*, for example, Atkinson and Dallas, *supra* at 67: "Life insurance is not well understood by most consumers. Except for term insurance, most products are very difficult to compare, even for insurance professionals. Permanent life insurance policies have so many elements that can differ (such as premiums, cash values, dividends, and death benefits) that it is impossible to rank them."

[58] Davis, William B., "Life Insurance: A Fiduciary Time Bomb," *Trusts & Estates* (May, 1992), pp. 35-38.

[59] Bohannon, David, "Methods of Evaluating Life Insurance," *Journal of Financial Planning* (April, 1996), pp. 20-22.

[60] Katt, Peter C., "Detecting Illustration/Policy Performance Abuses," *Journal of Financial Planning* (February, 1996), pp. 18-19. Alexander, Neil, "Understanding Life Insurance Illustrations," *Journal of Accountancy* (February, 2003), pp. 70-72.

> by virtue of current strength and past performance to deliver on the illustration. Does the carrier's record, in terms of dividend (or credited interest) history and results in mortality, interest, lapses, and expenses suggest it has delivered in the past and will continue to do so in the future?[61]

This certainly sounds like good advice and seems to be exactly what the grantor and beneficiaries would expect the ILIT trustee to do. However, insurance policies don't underperform because the carrier fails to achieve its line-of-business profit objectives. They underperform because the carrier credits the policy an amount insufficient to support ongoing administrative and actuarial costs that the policy (not the carrier) must bear. There is no necessary relationship between the accounting data on the financial statements of the carrier and the future values that can be reasonably expected by the policyholder. In short, the advice is misguided.

Although everyone can readily agree that the attempt to judge the merits of a car's automotive engineering by examining the financial statements of its manufacturer would be complete folly, nevertheless, advice on policy evaluation seems to recommend a comparable procedure. But what is the rationale for undertaking such a procedure if the academic evidence indicates that it does not provide meaningful information that enables the trustee to make judgments with predictive accuracy? Superior track records in the insurance industry are as ephemeral as those in the money management industry. This should not be surprising because insurance carriers invest in the same capital markets as other institutional money managers; and, it is rare in even moderately efficient markets to find investments that offer more than zero net present value when properly adjusted for their risk. Just as the persistence of abnormal returns generated by top-ranked money managers into future periods is often no better than chance, so also, the predictability of investment results from insurance carriers is low. Indeed, modern portfolio theory suggests that the best track record may merely reflect the fact that the winner assumed the highest amount of risk (and was fortunate enough to have the bets pay off during the period under evaluation).[62]

The above-quoted commentator offers another commonly offered piece of advice: namely, testing the credibility of policy illustrations by comparing the illustrated interest/dividend crediting rates against the published rate on investments currently earned by the company.[63] The logic of this advice rests with the assumption that illustrated rates in excess of the actual rate of return on the carrier's general investment portfolio are not sustainable. The general portfolio of an insurer, however, is merely an aggregation of segmented portfolios, each of which may back separate policy forms and each of which may have substantially different actuarial characteristics and competitive objectives. Indeed, in 1985, the National Association of Insurance Commissioners cautioned: "Sometimes a company's net rate of return on its investments is referred to in such a way as to suggest that the figure represents the yield on the "savings" component. This practice should be avoided because the company's rate of return on its investments is not indicative of the yield on the savings' component from the buyer's viewpoint."[64]

A carrier's rate of return on invested assets cannot be used to predict the performance of any particular type of policy because of the segmentation of the investment portfolio. Given the rate at which new policy types come into the marketplace, it is unlikely that even policy forms launched in the recent past would have the same profit objectives, expense assumptions, compensation structures, and so forth that are embedded in the new products.[65] Insurance companies establish asset management (*i.e.,* risk/return) objectives not only by line of business but also by segmented policy types with each separate form managed according to a strategy specific to its unique characteristics. As one study notes: "Each segment has its own return objective, risk parameters, and liquidity characteristics. A few companies have seg-

[61] Ratner, Charles L., "Life Insurance Policy Replacements: Real Peanuts Or Just A Shell Game?," *Trusts & Estates* (April, 2000), p. 26.

[62] Atkinson and Dallas, *supra* at 177: "Differences in interest rates earned by various companies are often more a function of the degree of risk-taking than differences in investment acumen."

[63] *See also* Gallo, Jon J., "Use of Life Insurance in Estate Planning," *Drafting And Administering A Life Insurance Trust*, Continuing Education of the Bar Berkeley, California Program Handbook (March/April, 1998), p. 15: "Using the Best's report for the company in question, determine the company's current net return." [The authors should also point out that there is only a tenuous relationship between dividend interest crediting or credited interest to Universal Life Policy accounts and the actual yields which depend on policy cash values.]

[64] "Report of the Yield Index Advisory Committee," NAIC Proceedings, (Vol. 1, 1986), p. 648.

[65] It has also been noted that product lines reflect historical changes in the tax code: "Product creation is based on the tax laws." Frinquelli, M.A., "Analyzing the Insurance Market—Internal and External Factors," *The Financial Services Industry—Banks, Thrifts, Insurance Companies and Securities Firms,* (AIMR, 1992), p. 76. *See also* Atkinson and Dallas, *supra* at 36: "Tax rules can make or break a particular type of product;" and, Collins, Patrick J. "Tax Motivated Life Insurance: An Exciting and Helpful Tool, " *ACTEC Journal* (Fall, 2003), pp. 107-113.

mented by product line and in some cases have established as many as 40 different segments."[66]

The above discussion on the futility of establishing a linkage between the rate of return on an insurance company's general account investments and the rate credited to policyholders can be generalized to other measures of profitability. Consider, for example, the widely cited measure of company profit margin. Profit margin is the present value of profits divided by the present value of premiums. It is tempting to hypothesize that companies with higher margins are better able to provide customers with superior product performance. Profit margin, however, "…is affected to a considerable degree by the choice of assumptions for the present value, and comparison of one company's profit margins with another's can be misleading unless there is some uniformity in the choice of assumptions. Unfortunately, there is no consensus on the appropriate assumptions, although many companies simply discount using the current rate of earnings on assets."[67] Similar difficulties occur when assessing other key ratios such as return on equity (depends on how a company defines the components of equity) and return on assets (depends on how a company carries asset values on its financial statements). Common measures of profitability and return are simply not comparable from company to company and cannot be reliably used as predictors of returns credited to individual policies.

Indeed, at the risk of pointing out the obvious, the opaque nature of the insurance contract makes it difficult even to determine the true interest rate that is being credited to the policy, not to mention comparing this "true rate" to the reported yield on the carrier's invested assets. Opportunities for interest crediting gamesmanship abound, for example, in new money universal life investment contracts. In new money contracts (as opposed to portfolio rate contracts), the credited rate depends on when the money was received; and, therefore, more accurately reflects the returns that were available in capital markets at the time of its investment. However, some insurance carriers debit older (higher interest) money pools with the contract's cost of insurance and administrative charges thus creating large discrepancies between the advertised interest crediting rate and the effective rate.[68]

Much academic evidence suggests that the predictability sought by due care commentators who seek to link carrier performance with individual policy performance may be elusive. Until more objective research can demonstrate the efficacy of this method of policy evaluation, it is difficult to see how an ILIT trustee can justify spending much time or effort pursuing this line of due care inquiry.

§2.5.2 Quantitative Methods of Performance Prediction

Some commentators recommend evaluating life insurance policies relative either to other policies or to other investment options by calculating projected rates of return. If the rate of return on an existing policy is unsatisfactory, the trustee, according to this advice, may want to consider:

- Acquiring a replacement policy; or,
- Exercising the option for policy surrender.

The implication is that rate of return calculation is a satisfactory way to document that the trustee executed a procedurally prudent decision making process; and that the quantitative nature of the process provides strong evidence that the trustee employed the requisite levels of care, skill, and caution demanded by UPIA.

When using quantitative analysis, however, it is important to use appropriate methods with sufficient integrity and explanatory power. This is a particularly troubling area because of the propensity of some com-

---

[66] Ambachtsheer, Keith P., Maginn, John L., and Vawter, J., "Determination of Portfolio Policies: Institutional Investors," *Managing Investment Portfolios: A Dynamic Process,* Eds. John L. Magninn and Donald L. Tuttle (Warren, Gorham and Lamont, 1990), pp. 4-57. *See also* Cabanilla and Brodie, *supra* at 78: "An overwhelming majority of the surveyed companies…used segmented assets as the primary method of determining net investment income by line of business."

[67] Easton and Harris, *supra* at 48.

[68] This is not, however, a justification for selecting, without critical examination, a Whole Life or Universal Life contract because it credits policyowners based on portfolio yields rather than new money yields. One of the more common myths of the insurance industry is the contention that, in the long run, portfolio yields and new money yields should produce equivalent expected values. This is true only when a company's asset portfolio is devoid of investments with interest-rate optionality. When new money rates decline, portfolio rates do not adjust slowly. Call options and prepayment options force companies to invest significant amounts of "long term" capital at the new short-term rates. Thus, the company's portfolio rate is more likely to adjust downwards towards a declining new money rate than it is to adjust upwards towards an increasing new money rate. This is another variation on the general risk of asset/liability management.

mentators to employ inappropriate methodologies that lead to incorrect conclusions.[69] The best example of a faulty quantitative policy evaluation methodology is the calculation of a policy's death benefit internal rate of return. The internal rate of return (IRR) expresses the relationship between projected death benefits and premiums paid. In policy replacement sales pitches, this often takes the form of a question along the lines of "if I could obtain a policy that offers 40% more death benefit for the same premium, would you be interested?"[70] The IRR is a single number that expresses the rate at which money committed to the insurance policy (and remaining in the policy) compounds. As such, IRR is comparable to the rate earned on a savings account. If beneficiaries receive an early death benefit after payment of only one or a few of the scheduled premiums, the IRR will be very high. If they must wait many years for receipt of policy proceeds, the interest rate that equates premiums paid to benefits received will be lower.

Trustees are sometimes told that policies can be compared and evaluated based on the calculated IRR. However, with respect to a life insurance policy, the IRR measure is *inappropriate* because it ignores both the scale of premium commitment as well as risk of future contract lapse due to underperformance. To a great extent there is an *inverse* relationship between a high IRR and the cash-value base upon which the contract depends for its future integrity. Therefore, the higher the IRR, the greater the risk of lapse because future interest or dividend credits may be insufficient. Furthermore, changes in premium inputs and time horizons can sometimes lead to widely varying IRRs with the result that inferior products may actually replace adequately performing policies simply because the sales illustrations are manipulated by agents.[71]

Although reductions in scheduled premiums will, all else equal, enhance the death benefit IRR, premium reduction simultaneously increases the risk of lapse due to insufficient cash value. Indeed, the 1985 report of the Yield Index Advisory Committee of the National Association of Insurance Commissioners stated that calculating a death benefit internal rate of return was misleading.[72] However, the death benefit IRR calculation is sometimes the basis for advice to dump policies that are, allegedly, outdated and underproductive. For example, the following commentary on managing trust-owned life insurance (TOLI) policies notes: "few trustees have provided the requisite review and management." It continues:

> …the primary purpose of an irrevocable life insurance trust is to maximize the death benefit. Cash value accumulation is only a premium financing decision which should closely be considered and documented by the trustee…. For an existing TOLI policy, grantors, beneficiaries and their legal advisors expect the trustee to address two obvious questions through the annual monitoring function:
>
> - Can more death benefit be purchased for the same premium outlay?
> - Can the same death benefit be purchased for less outlay?[73]

Based on this somewhat single-minded view of the role of the life insurance trust,[74] the authors "prove" that up to "74 percent of single life policies

[69] The Federal Trade Commission under President Carter, mindful of this problem, encouraged states to adopt a "Linton Yield" method for insurance cost disclosure. The Linton Yield method selects a particular planning horizon (*e.g.,* twenty years) and compares cash value insurance with a term insurance policy plus a side fund. The rate of return that brings the fund into equilibrium with the policy's cash value is the Linton Yield, which is an implied rate of return on the policy's cash value component. The Linton Yield cost disclosure method remains in use, although the states adopted NAIC recommended interest-adjusted cost indices. For a comprehensive discussion of the Linton Yield's merits and disadvantages, see Auxier, Albert L., "The ABC's of the Linton Method," *CLU Journal* (October, 1981), pp. 44-49. For a discussion of methodologies appropriate for determining the merits and disadvantages of policy replacements, see Carson, James M., and Forster, Mark D., "On the Merits of In-Force Cash Value Life Insurance," *Journal of Financial Service Professionals* (2002), pp.69-75.

[70] One actuary estimates: "the cannibalizing of existing whole life policies reached a zenith in the mid-1980s when one in every two sales of a cash value policy was a replacement." Hunt, James, H., "Life Cost Disclosure: Prospects for True Reform," *Journal of Insurance Regulation* (Summer, 1995), p. 406. Hunt is a former insurance commissioner; and he provides a life insurance policy evaluation service under the auspices of The Consumer Federation of America (www.consumerfed.org/rorflyer.pdf.). Mr. Hunt prefers a "Yield Index" method of cost disclosure comparable to the "Linton Yield" method of calculating the investment return on the cash value component of life insurance.

[71] An excellent review of quantitative methods of insurance cost measurement is found in Bartlett, Dwight K., "Life Insurance Cost Disclosure: A Regulatory Viewpoint," *Journal of Insurance Regulation* (Summer, 1995), pp. 432-439. Bartlett describes the history of cost disclosure calculation methods as well as several common and egregious methods used to manipulate them.

[72] NAIC Proceedings, Vol. I., 1986, p. 647.

[73] Whitelaw, C. Markham and Reis, William C., "Managing Trust-Owned Life Insurance Revisited," *Trusts & Estates* (April,1999), p. 38.

[74] By contrast, Donato and Benesh list eight rationales for establishing and maintaining an ILIT. *See* Donato, Linda F. and Benesh, Bruce K., "Irrevocable Life Insurance Trusts," *The Tax Adviser* (July, 1994), pp. 395-396. For additional creative uses of ILITs in estate planning see Fogel, Bradley, "Life Insurance and Life Insurance Trusts: Basics and Beyond," *Probate & Property* (January/February, 2002), pp. 8-15.

and 85 percent of Survivorship policies" are candidates for replacement. As the line of thought is pursued to its end, the authors give professional trustees the "good news" that a replacement campaign can be a marketing tool to expand the trustee's business. A new standard of prudent asset management, based on the morals of the marketplace, emerges: "Properly structured, TOLI management is *a marketing program* bringing multiple services to the client while documenting procedural prudence" [emphasis added].[75] Even if the conclusions of the authors are correct (although most academic commentators suggest that replacement is usually not warranted), there is the possibility that a marketing-oriented trust administrative system might leave trustees vulnerable to a perceived failure to uphold the duty of loyalty because of collusion and self-dealing sales activities.[76] This is an emerging and important liability issue for commercial trustees with linkages between banking services, trust services, and life insurance carriers.

Even when appropriate rate of return methods are used, the trustee still confronts at least two problems:

1. How credible are policy projections that provide the data for the return calculations?
2. How credible are the results of calculation methodologies based on point estimates rather than range estimates?

The most precise calculations cannot assist the trustee to make good decisions if they utilize unreliable data. Additionally, many of the common methods of quantitative analysis are based on solving equations to calculate either returns or present values based on point-in-time estimates. For example, the Yield Comparison Index method calculates an equivalent yield (*i.e.*, rate of return) on insurance policy cash value assuming that the contract is surrendered in a specific future year. Such a calculation requires a precise dollar estimate of cash surrender value many years into the future. The likelihood of accurate estimation, however, becomes increasingly poor as the time horizon of the analysis expands.[77]

Generally speaking, the traditional quantitative methods for determining life insurance policy costs divide into:

1. Event specific methods; or,
2. Group average methods.

---

[75] Whitelaw and Reis, *supra* at 43. There may be emerging a cottage industry of "independent advisors" offering their services to trustees based on the pitch that policy reviews can generate additional sales commissions for banks affiliated with life insurance carriers. *See,* for example, Barney, Austin D., "TOLI Due Diligence Can Yield Sales," *National Underwriter* (April 13, 1998). Despite the fact we do not address the topic of policy replacement directly in this article, it is, nevertheless, important, and has generated an increasing amount of litigation. Virtually all states have adopted some version of the NAIC Model Replacement Regulations which direct that the replacing agent must provide the policyowner with a Replacement Notice warning of possible disadvantages, must notify the carrier of the policy to be replaced, and, in some states, must provide a Comparative Information Form projecting the relative performance of each policy. Hunt, "Life Cost Disclosure: Prospects for True Reform" characterizes replacement regulations as "How-to-do-it Kits" for agents and brokers, supra at 406. For a review of litigation issues surrounding policy replacement activities as well as other "market misconduct" allegations against the life insurance industry, see Egler, Frederick N. and Malak, Paul J., "The Individual Life Insurance Sales Practice Case: A Litigation Primer," *FICC Quarterly* (Fall, 1999), pp. 1-28.

A recent example of how UPIA language can be misused for the purposes of advancing a transactional agenda (in this case, policy replacement) is found in Whitelaw, Randolph E. and Weber, Richard M., "Trust Owned Life Insurance: Risk Management Guidance for Fiduciaries," *Estate Planning Journal* (September, 2005). The authors, although protesting that they do not intend "…to suggest that the wholesale replacement of life insurance is appropriate," nevertheless strongly suggest that approximately 35% of in-force TOLI policies should be replaced by no-lapse guarantee products in order to mitigate trustee risk of determining and managing premium adequacy for policies with non-guaranteed premiums. UPIA phraseology is manipulated into prescriptive statements implying that the sole path to prudence lies along the track of greatest financial advantage to the trust investment "consultant": "If a trustee does not obtain the grantor's approval, or lacks TOLI risk-based procedures or expertise in policy evaluation, the trustee must recommend restructuring to a guaranteed death benefit policy." Although mitigating trustee risk may be a laudable goal, prudent asset management for the benefit of trust beneficiaries is a paramount fiduciary obligation. A more balanced and thorough discussion of the risks of selecting no-lapse guarantee policies for trust owned policies is found in Bannen, John T., "No Lapse Guarantee Life Insurance Policies: The Answer to an Insured's Prayer or a Fiduciary Nightmare?" *ACTEC Journal* (Spring, 2005), pp. 246-250; and Bannen, John T., "No Lapse/Secondary Guarantee Life Insurance Policies," *ALI-ABA Sophisticated Estate Planning Techniques* (Boston, Massachusetts, September 8-9, 2005). Robert Stein, chairman of Ernst & Young's Global Financial Services department, sees "…a disturbing parallel between the current-day presentation of no-lapse products and the sale of vanishing premium products in years past. Each represents an easy sale." Stein hypothesizes that the litigation fallout from such sales could trigger the next "debacle for the life industry, raising the specter of lawsuits and damaging allegations regarding the insurance sales process." Stein, Robert W., "No-Lapse Policies Pose Risk," *Best's Review* (April, 2005), p. 74. *See also* Collins and Jurkat, *supra.*

[76] Although constraints on trustee self-dealing and other conflicts of interest vary from state to state, OCC regulation 12 CFR §9.12 prohibits self-dealing between national banks and their subsidiaries and affiliates including insurance corporations. *See also* Moore, Donald F., "The Duty of Loyalty and the Responsibility of the Fiduciary—A Regulator's Perspective," *Trusts & Estates* (May, 2000), pp. 40-41 and p. 79.

[77] Collins, "Is It Prudent and Suitable?" *supra* at 6.

Event specific methods are the more common methods used to calculate life insurance costs. They focus on the customized and specific insurance illustration prepared for the policyholder. Generally, event specific methods seek to determine the cost of an insurance policy (and, by implication, to compare competing policies) by taking illustrated dollar benefits at their face value. Examples of event-specific methods include the Death Benefit IRR and the Yield Comparison Index methods as well as Linton Yield (implied rate of return on projected cash values); Equivalent Level Annual Dividend method (for participating whole life contracts); and net present value cash flow calculations.[78] The key point, however, is that event specific methods can determine the true cost of life insurance only if every assumption underlying the product illustration (either sales proposal or in-force policy illustration) occurs exactly as predicted for the individual buyer. At the end of the day, this method generates a precise cost expectation that ILIT trustees should never expect.

Group average methods, by contrast, do not measure the insurance cost for individual buyers but rather the average cost for the group of consumers electing to purchase the policy. The Group Average method generates an expected average, and does not forecast the exact cost of insurance for any individual. This said, however, group average methods may be superior to event specific methods for a variety of important reasons. When considering, over time, the total experience of a group of policyholders, the method incorporates critical dynamic variables such as lapse ratios, survival probabilities, non-forfeiture values, etc. Thus, a group average method includes multiple "discounting" operations for interest, policy retention, and mortality experience. The dimension of time incorporates factors for time value of money (similar to the Yield Comparison Index method), and provides a more comprehensive year-by-year picture of insurance policy costs and benefits.[79]

§2.5.3 Testing the Policy Illustration

The National Association of Insurance Commissioners, in 1994, stated, "Illustrations are not and cannot be predictions or estimates of future performance."[80] However, despite this caveat, much due diligence advice tries to tease out future performance parameters by using the illustration as a kind of base case: "Always ask for an alternative illustration with reductions of 100 basis points or a 1% drop in the rate and 200 basis points or a 2% drop in the rate."[81] However, critical evaluation of the proposed insurance plan requires examination of the timing, risk, magnitude, and probability of all cash flows according to generally accepted standards of statistical and quantitative financial analysis. Unfortunately, this involves something more than having the agent recalculate illustrated values using alternative interest rates.[82]

Most of the illustration testing procedures consist of multiple scenarios or "what if" analyses. What if the credited interest rate dropped by one percent; what if the costs of insurance coverage rose to their maximum guaranteed level? This type of testing provides limited information to the trustee. Actual insurance policy dollar values are generated by the dynamic interaction of many return variables operating in an environment of interactive complexity.[83] Such environments are often characterized by conditional probabilities and non-linear results. Thus, a "what-if" analysis may miss the mark. A "what if" analysis takes an illustration and examines

[78] Mehr and Gustavson, *supra* at 135-143. *See also* Bohannon, *supra* at 20-22.

[79] The 1979 report of the Federal Trade Commission *(Life Cost Disclosure: Staff Report of the Federal Trade Commission)* that calculated a return of only 1.3% for whole life policies was based on a group average calculation methodology. Although each insured's return is unique, on average, the life insurance buyer fares poorly because of the propensity to lapse or surrender policies obtained in the face of high acquisition costs.

[80] *See also* "Final Report Of The Task Force For Research on Life Insurance Sales Illustrations Under The Auspices of The Committee For Research On Social Concerns," *Transactions of Society of Actuaries* (1991-92 Reports), p. 140: "How credible are any nonguaranteed numbers projected 20 years into the future, even if constructed with integrity? How does a consumer evaluate the credibility of two illustrations if they are from different companies or even from the same company if different products with different guarantees are being considered? Most illustration problems arise because illustrations create the illusion that the insurance company knows what will happen in the future, and that knowledge has been used to create the illustration…. Within North America in other financial products such as mutual funds, it is recognized that future performance cannot be illustrated. The emphasis of these illustrations is to disclose expense charges, not the performance of the underlying fund. Life insurance policies are complex financial contracts. There is no simple measure or analysis to compare future performance of unpredictable events. This fact is well understood in the securities industry and needs to be assimilated into the life insurance industry as well."

[81] Gallo, Jon J., "Use of Life Insurance in Estate Planning," *Drafting And Administering A Life Insurance Trust*, Continuing Education of the Bar Berkeley, California Program Handbook (March/April, 1998), p. 15.

[82] *See*, for example, Carson, J.M., "Determinants of Universal Life Insurance Cash Values," *The Journal of Risk and Insurance*, Vol. 63, No. 4 (1996), p. 678: "The results of the multivariate analysis indicate that ignoring expense, mortality, and surrender charges within universal life policies is likely to lead to erroneous conclusions when attempting to identify competitive universal life policies."

[83] As well as by the way the carrier elects to allocate expenses and interest rate credits.

changes in dollar values resulting from changes in isolated determinants of return (increase or decrease in lapse rate, interest credits, and so forth). Additionally, the variable of interest is usually changed in a predetermined fashion with all other variables held constant.

Even if "what if" methodologies could yield useful insights, they may fail when applied to insurance policy illustrations. The determinants of illustrated policy dollar values cannot be disentangled. You cannot, for example, assume that the interest rate crediting component in a universal life policy illustration reflects only interest earnings on underlying assets. Although clear disclosure regarding important policy elements was a marketing promise made by insurance carriers when Universal Life products first appeared, "not only are high early expenses now covered by a surrender charge, but mortality charges may frequently include expense or income tax, and interest rates credited may even be reduced by expense costs other than investment expense."[84]

Fortunately, projections for new insurance coverage must depict the worst-case scenario in the guaranteed values column of the sales illustration. Additionally, most insurance carriers can illustrate guaranteed values for existing policies on in-force illustrations. Therefore, some of the "what if" tests indicate the degree to which policy values are sensitive to small changes in relevant variables. However, the actual assumptions that underlie policy illustrations are proprietary information; and, without knowing the underlying assumptions, it is difficult to determine how single variable changes illuminate actual policy risks.

Actuaries, in part, focus on the risk that the assumptions underlying product development and pricing are misspecified or incorrectly determined. Actuaries term the risk that a pricing model's flaws preclude corporate profitability objectives "pricing risk." If there is a high degree of pricing risk (*e.g.*, *each* relevant variable can be at the upper bound of "reasonableness" at some time but the assumption that *all* variables exhibit favorable interaction for most or all of the time may be unreasonable), then there is a high probability that the insurance contract will fail to deliver adequate return on equity to the carrier; or will fail to deliver projected values to the policyholder absent additional premiums.

The NAIC approved the Model Regulation of Life Insurance Illustrations in 1995. It provides for the appointment of an Illustration Actuary responsible for certifying the reasonableness of non-guaranteed elements in the product illustration. The regulation specifies rules for construction of a "Disciplined Current Scale" and requires a set of testing procedures in order to determine the viability of the product illustration.[85] Actuarial Standard of Practice #24 governs the methodology to determine that the product illustration is self-supporting. Actuarial assumptions must be based on "recent historical experience."[86] Thus, a reasonable assumption is merely one that corresponds to the limits of current experience for the product line being illustrated. With the continuous creation of new product lines backed by segregated investment portfolios, there is little long-term experience history; and, illustrated values may bear little resemblance to actual future outcomes: "Life insurance contracts usually extend over many years, and it is impossible for the issuing company to predict the actual cost of insurance on a reasonably accurate basis."[87] Additionally, regulations for allocation of expenses ("fully allocated" vs. "marginally allocated") permit great latitude in future dollar value projections on an insurance illustration.[88]

The uncertainties that characterize this state of affairs are nicely captured in a story that circulates at actuarial conferences:

> In the old days … it was easy. The CEO used to give a profit goal for a product. Then the marketing man would tell you the product design. The actuary knew what the assumptions were and solved for the premium. Now…it's a lot different. The CEO still gives me a profit goal, and the marketing guy not only gives me the product design, he gives me the premium, and I have to solve for the assumptions.[89]

[84] Easton and Harris, *supra* at 17.

[85] *Id.* at 150-151.

[86] *Id.* at 226-227.

[87] *Id.* at 135. *See also* Atkinson and Dallas, *supra* at 114: "Actual experience is not always credible…."

[88] Atkinson and Dallas, *supra* at 910: "In order to field competitive products, some companies knowingly price using unit costs below their actual unit costs. To compensate, such companies simultaneously pursue an expense reduction campaign, with a goal of bringing actual unit costs down to the level of assumed unit costs, at some time in the not-too-distant future. In some cases, this may be wishful thinking."

[89] Lennon, *supra* at 17. This humorous anecdote underscores the fallacy of another common myth regarding life insurance—namely, insurance pricing is a function of strict actuarial expectations. Atkinson and Dallas, *supra* at 71-72, for example, discuss pricing options available to manufacturers of insurance products. While it is true that regulators prohibit predatory pricing practices, nevertheless, many products are priced according to adaptive ("eventually, most companies in this category will exit the business or be acquired") or opportunistic pricing strategies ("profit margins will be thinner") that may have little to do with the input of the actuary.

Although intended to be humorous, this tale is not too far off the mark. The ILIT trustee purchases a contract that promises only the guaranteed values. Additional projected benefits are forthcoming if the assumptions that underlie the pricing model unfold, as predicted, over time. The likelihood that such additional benefits will unfold exactly as predicted is remote; and, this is a reason why some quantitative rate of return methods are not as helpful in policy evaluation as might be expected. One commentator sums up the current state of policy illustration credibility in the following terms: "…the NAIC's attempt to eliminate illustration abuses is producing underwhelming results…the regulations apparently can be interpreted to allow companies to continue the game of illustration liar's poker by making unsupported exaggerated policy values promises."[90]

Academic studies provide a caution to trustees who must carefully evaluate the credibility of projected dollar benefits either on new sales illustrations or on inforce policy illustrations. The trustee is faced with a seemly insurmountable task because it is impossible to obtain a road map through the myriad of assumptions underlying such illustrations; and, therefore, impossible to know in which direction you are moving as you make changes in individual variables. Conventional wisdom regarding the value of and the strategies for testing product illustrations appears to be largely inadequate from the standpoints of both methodological correctness and legal defensibility. We find, however, that the typical insurance advice literature places the trustee squarely in the middle of an insolvable dilemma. The trustee, according to life insurance counselors, must evaluate the costs and benefits of new or existing insurance policies lest the beneficiaries be shortchanged because the trustee invested in inferior products. But such evaluation necessarily involves forecasting costs and benefits that, according to actuaries, the product manufacturers themselves cannot predict with a reasonable degree of accuracy. The next section explores the nature and magnitude of the trustee's quandary.

---

[90] Katt, Peter, "Deciphering Cash Value Life Insurance Illustrations," *Journal of Financial Planning* (October, 1997), p. 33. The response of the insurance industry to the NAIC model illustration legislation is of particular interest. We reproduce an announcement released on December 11, 1996 by a major insurance company regarding how the new NAIC regulations alter their marketing as of 12/31/96. Names of specific products are changed to "generic" labels:

> PRODUCTS TO BE REPLACED, WITHDRAWN, OR NOT ILLUSTRATED:
>
> Product A & Product B and Product C will be withdrawn in the states adopting the rule….In states with a 1/1/97 effective date, applications for the … products must be received in [company's name] office no later than December 31.
>
> Products D and E will no longer be available in any state. Applications must be taken by 12/31/97.
>
> Product F will continue to be available in all states but will only show guaranteed elements on the illustrations.
>
> Product G will be designated as a "non-illustrated" product in adopting states. Software support will no longer be available.

Announcements such as this leave one to wonder about the integrity of the product lines available for sale up through the end of 1996. The announcement regarding the shake-up in product availability does not suggest that owners of past policies will be alerted to the fact that such products have been withdrawn from the market; nor does it suggest that agents have been instructed to inform their clients regarding these developments. If anything, it suggests that agents should hurry to complete sales of Products D and E before they are regulated out of existence. *Caveat Emptor.*

Spotlight on Attorneys' Fees

Compiled by Martin A. Heckscher
West Conshohocken, Pennsylvania

This report, which is a regular feature of ACTEC Journal, *focuses on significant recent court decisions and rules, legislative enactments and IRS developments bearing on attorney compensation in the trust and estate practice. The report is heavily dependent on the willingness of all the Fellows to furnish material that they think would be suitable for inclusion. Please send* Spotlight's *compiling editor a brief write-up (as little as one paragraph will do) about a recent case, rule, statute or ruling which you believe is important in the jurisdiction in question or of widespread interest.*

FLORIDA
Robert B. Fleming, Tucson, AZ

Settlement of Contested Guardianship Proceeding Construed to Bar Payment of Attorneys' Fees after Agreement Reached

In the middle of the trial of a contested guardianship, the ward's children settled their competing petitions by an agreement which was dictated into the record. One element of the agreement limited payment of attorneys' fees from the ward's estate to $25,000 for each side, with any additional litigation fees or costs to be the responsibility of each party. Because implementation of the agreement proved more difficult and time-consuming than anticipated, the attorney representing the ward's daughter serving as guardian of her person (and trustee of several trusts for her benefit) sought an award of an additional $13,750 in fees and costs incurred for services to perform and conclude the agreement. Despite the opposing side's objection, the trial court approved the additional fee for the guardian's attorney and also a fee for the guardian herself, finding that the agreement did not limit her attorney's fee for additional services to the $25,000 agreed to for each side's attorney or preclude her from collecting a fee as guardian. The District Court of Appeal reversed the attorneys' fee award, finding that the agreement expressly limited his fee to payment for services rendered "for this litigation," which included implementation of the agreement. The appellate court noted that the extensive nature of the legal work necessary to implement the agreement was apparent to all parties when they reached the agreement in the first place and that allowing an additional fee for the guardian's attorney alone and not for the other side's attorney (who had claimed none) would violate the agreement's mutuality. The court also held that the guardian of the person was not required to (and did not agree to) serve without compensation. Because the evidence was insufficient to support her fee award, it remanded the case to the trial court to hear further evidence on that issue. *In re Sapp Guardianship,* 868 So. 2d 687 (Fl. App. 2d Dist. 2004).

NEW YORK
Roger Simon, Buffalo

Attorney's Flat Fee of $330,000 Approved for Administration of Substantial Estate Based on Quality and Quantity of Attorney's Services Where Recorded Time Was Notably Low; Terms of Fee Agreement Upheld as Reasonable

On March 21, 2006, the Surrogate's Court of Monroe County approved an attorney's fee of $330,000 for representing a bank as executor of an estate valued at $15.5 million. *Estate of Cleveland,* No. 2003-2045/B (3-2006). The will gave the residuary estate to two charities, who consented to the fee. The attorney general as statutory representative of the charities opposed the fee and argued that it should not exceed $145,000 because the time expended on the estate was "minimal." The court noted that probate of the will was concluded easily and within weeks of death; the personal property was distributed swiftly and without contention; both federal and state estate tax returns were accepted without audit; the legatees received substantial distributions within a few months of decedent's death; and the petition to close the estate was filed less than two years after death, which the court described as "a very expeditious feat." The surrogate attributed these factors to the skill of the attorney and his familiarity with decedent's financial and legal affairs for years before her death.

The decision also relied heavily on the attorney's engagement letter, signed by the executor at their initial meeting, in which he agreed to charge a fee equivalent to one executor's statutory commission, which the court noted was a common practice in the community. Having observed that the "legacies were maximized by [the attorney's] tax advice and skill in keeping this estate from incurring any tax liability whatsoever," the court was favorably impressed that the attorney had agreed to handle tax or other litigation, including any audit of the death tax returns, at no additional fee. [Reporter's note: Review of the will and other court records discloses that the estate plan was designed to avoid payment of any estate tax and, in fact, that no tax was paid.] The court determined that the agreement with the executor was reasonable, and, while it ultimately worked in the attorney's favor, the Surrogate saw no reason not to give him the benefit of a flat fee arrangement that could have benefited the other side.

The court concluded that the attorney had made a prima facie showing that the fee was reasonable. By contrast, the assistant attorney general relied solely on the attorney's time records in arguing that the fee should be $145,000 and presented no expert testimony or other evidence to buttress her argument. Without much difficulty, the court dismissed her "hours only" argument after observing that the number of hours spent on the estate was "notably low." In disposing of the attorney general's argument, the court stated that

> The true test ought to be the quality and quantity of the work done for the estate, quantity being measured by output and product rather than hours expended….
>
> To evaluate "work performed" any other way would encourage a problem from the opposite end of the spectrum—inflation of hours (padding), which would be more problematic than the current situation because it is disingenuous on the part of the attorney and creates no benefit for the client or value to the estate. [citation omitted]

The court readily distinguished the cases and general principles cited by the assistant attorney general to support her position, pointing out again that "'work' is defined by more than hours billed."

OHIO
Jeffry L. Weiler, Cleveland

Time Spent by Paralegal Was Properly Chargeable as Part of Attorney's Fee in Probate Court Proceeding

Attorney Marc Dann was retained to assist with a complex adoption proceeding before the Mahoning County Probate Court. Dann's agreement with his clients provided for billing rates of $175 per hour for his time, $110 for an associate and $90 for his paralegal. The probate court eventually entered a final decree of adoption. Thereafter Dann petitioned for extraordinary fees and expenses. The court disallowed all fees related to the paralegal's services, stating that it had long been the court's position that it does not include a paralegal's time as part of an attorney's fee. The paralegal's services (27 hours in this case) was considered, along with secretarial support, to be part of the attorney's overhead and not separately billable. Dann having appealed, the Seventh District Court of Appeals noted that the probate court has limited jurisdiction and can only exercise such powers as are conferred upon it by statute and the state's constitution. The statute gives it exclusive jurisdiction over adoptions and permits disbursements for attorneys' fees in adoptions. Ohio Rev. Code Ann. §3107.10(C)(3). The attorney must file a final account specifying all disbursements of value concerning the adoption. The court may reduce any amount that it finds unreasonable. The payment of a reasonable attorney's fee lies within the probate court's sound discretion. An abuse of discretion will be found if the court's decision is not supported by the record or is contrary to law.

The appellate court noted also that the probate court's disallowance of a fee based on a paralegal's services or time was directly contrary to Ohio case law, including decisions by five other District Courts of Appeals. See *Jackson v. Brown* (1992), 83 Ohio App. 3d 230 (8th Dist.) (fees attributable to legal assistants properly employed and supervised may decrease litigation expenses and their use should not be discouraged but should be permitted as part of an award of attorneys' fees); *Ron Scheiderer & Assoc. v. London*, (Ohio App. 12th Dist., Aug. 5, 1996) (No. CA95-08-022) affirmed on other issues, 81 Ohio St. 3d 94 (paralegal time properly considered part of attorneys' fee). In its opinion, the Twelfth District Court of Appeals had observed that many attorneys now charge lower hourly rates and bill clients directly for paralegal time and for other disbursements. Expenses that can be clearly and directly traced to the cost associated with a particular matter are not properly considered part of an attorney's "overhead." While other appellate courts have reached the same conclusion, the Ohio Supreme Court has not yet directly addressed this issue. Recognizing that the Mahoning County Probate Court had no binding precedent on the subject, the District Court disagreed with its position and held that the paralegal's efforts in this case were "clearly and directly traceable to the work" Dann performed for his clients and, therefore, were properly chargeable as part of his fee and could not be disallowed as overhead. *Adoption of Bruner,* (Ohio App. 7th Dist., February 2, 2006).

PENNSYLVANIA
Bernard Glassman, Philadelphia

Dilatory Attorney Who Did Not Perform Rudimentary Tasks of Estate Administration Required to Refund Retainer; Successor Counsel's Fee Approved; Court Applied Principle That Only One Reasonable Fee Is Allowed Where Two Attorneys Serve Consecutively; Attorney's Retention of File to Await Resolution of His Fee Claim Criticized as Egregious and Never Justified

David Bilder was directed to file an account of his administration of a decedent's estate. *Gottlieb Estate,* 26 Fid. Rep. 2d 52 (Mont. O.C. 2005). Bilder, who was inexperienced in administering estates, failed to comply with the court's first order. He filed an account only after the court issued two additional orders to his prior counsel, John LaRocca, directing LaRocca to deliver the estate file to successor counsel to enable him to file the account. An evidentiary hearing was held on a petition for return of LaRocca's fees filed by successor counsel on Bilder's behalf. At the hearing LaRocca estimated that he spent 175 hours working on the estate and that, at his $150 hourly rate, he was entitled to $50,000 above the $25,000 he had received as a retainer. LaRocca also claimed that the administrator had agreed to his fee proposal of six percent of the gross estate, although Bilder denied that such an agreement had been reached and testified that he felt that LaRocca was not competent as his counsel.

In adjudicating the petition for return of attorneys' fees, the court adopted the approach of several earlier cases in which Pennsylvania's trial courts have explained that the percentage guidelines set forth in *Johnson Estate,* 4 Fid. Rep. 6 (O.C. Chester 1983), should only be used as a rule of thumb and that the court must ultimately decide what is fair and reasonable under the circumstances. Further, percentage guidelines should only be used absent evidence concerning the actual efficacy, or lack thereof, of the attorney's services. In adopting this approach, the court determined that the auditing judge must examine both the quantity and quality of the legal services performed. Based on its examination, the court directed LaRocca to refund the entire $25,000 that he had previously been paid.

In order to determine LaRocca's claim to his fee, the court alluded to the nine factors enumerated in the leading appellate case on fees in estates, *LaRocca Estate,* 431 Pa. 542 (1968), including, in particular, the amount of work performed, the difficulty of the problems involved and the professional skill of the attorney. In light of the fact that LaRocca kept no record of his own hours, the court noted that contemporaneous time records are indispensable in applying the foregoing factors. The court also stated that "time records often reflect the quantity of time spent and not the quality of services rendered [and that] time expended is not necessarily a reliable indicator of the quality of services rendered." Applying these principles, the court found that LaRocca, who acknowledged that he was dilatory in administrating the estate, failed to perform even the most rudimentary tasks required to administer an estate, that he was grossly unprepared to represent an estate of this size (approximately $800,000), that he was neglectful in his representation and that his neglect caused the estate to bear unnecessary expenses (including successor counsel's fee). LaRocca did not prepare the inventory, notify interested parties, maintain financial records or prepare death tax returns. Indeed, LaRocca did not prepare an account of the administration even when Bilder was under court order to do so. He also did not return Bilder's repeated phone calls and, upon questioning by the court, admitted that he was unaware of the concept of post mortem tax planning and that he had never previously represented a sizeable estate.

Lastly, the court approved just under $30,000 as successor counsel's fee, which was the amount established for an estate of this size by the *Johnson Estate* guidelines. The principle that applies when more than one attorney serves consecutively is that the total attorneys' fees must be limited to one reasonable fee. Because successor counsel performed substantially all of the duties for administering this estate, the court directed LaRocca to refund his entire fee. The court also commented that LaRocca's retention of the file pending resolution of the fee dispute was "particularly egregious" because successor counsel needed the file to prepare and file Bilder's account pursuant to the court's order, which LaRocca had ignored. While an attorney may retain a file to await payment of his outstanding fee in certain circumstances, "retaining an estate file in order to collect a fee is never justified in estate administration because the Orphans' Court provides a ready forum for resolving fee disputes."

PENNSYLVANIA
Karen A. Fahrner, Bryn Mawr

Following Appellate Court's Dismissal of Attorney's Appeal of Order Reducing Fee by Half, Appellate Court Remanded Guardianship Case to Lower Court to Hold Hearing on Attorney's Fee Claim

Pennsylvania attorneys have been following *In re Chesney Estate* closely because of its possible impact on claims for attorneys' fees in guardianship proceedings. In the initial decision, the Orphans' Court Division of Allegheny County denied attorney Fingeret's claim to be paid by the guardianship estate for services rendered after appointment of the corporate co-guardian. In reducing Fingeret's fee by more than fifty percent, the court commented that the guardians should pay for such services out of their personal funds or guardianship commissions, not out of the guardianship estate. See *In re Chesney Estate*, 24 Fid. Rep. 2d 313 (O.C. Alleg. 2004), discussed at 31 *ACTEC Journal* 81 ("*Chesney I*").

On May 6, 2005, a three-judge panel of the Superior Court dismissed Fingeret's appeal in a non-precedential decision with one judge dissenting. The majority held that Fingeret had not properly preserved the attorneys' fee issue for appellate review. Having decided the case on that basis, the court went on to state that even if Fingeret had properly preserved the issue, it would not afford him any relief on the merits of his fee claim because the guardians had failed to meet their burden to show that Fingeret had performed specific legal services justifying his fee. If the guardians had met their burden, the trial court could properly determine what to award in attorneys' fees. In this case, the majority explained, Fingeret had improperly "short cut this procedure [by petitioning] the trial court on his own behalf." On July 13, 2005, the Superior Court issued a per curiam order withdrawing its May 6, 2005, decision, granting panel reconsideration and directing Fingeret to take certain steps to perfect the appellate record with no party having to file additional briefs. By another per curiam order on October 14, 2005, the appellate court relinquished jurisdiction and remanded the matter for the trial court to conduct a hearing on Fingeret's fee claim as well as unrelated issues that had been previously raised on appeal. So much for *Chesney II*. Stay tuned for *Chesney III*.

PENNSYLVANIA

Bernard Glassman, Philadelphia

Attorney Required to Refund Fee and Pay Costs of Insolvent Estate Because Guardianship and Decedent's Estates Were Insolvent and Opening Decedent's Estate Was Unnecessary

Joan Ellenbogen served as guardian of the estate of Mrs. Humphreys, an incapacitated person. Upon Humphreys' death, Ellenbogen had herself appointed administratrix of the estate. Ellenbogen retained her husband, Handelsman, as attorney for both the guardianship estate and the decedent's estate. Together the couple paid themselves $1,900 in fees for handling the insolvent decedent's estate, or approximately 22.5% of the estate's assets of $8,425. Because the claims against the estate far exceeded its assets and all claims could have been paid (or partially paid) from the guardianship estate, the court found that opening a decedent's estate was unnecessary and ordered repayment of the fees and advertising and filing expenses paid from the estate.

Ellenbogen's primary complaint was that the guardianship and attorneys' fees charged were necessary and reasonable for administering the estate. The court determined, however, that because the guardianship estate was insolvent, there was no need to open a decedent's estate and incur the costs of administration. Ellenbogen further complained that the court denied due process by not holding a hearing on the reasonableness of the fees. However, Ellenbogen never filed a petition for allowance, which would have led to a hearing on the guardianship fees, nor did she request a hearing on the estate fees after the court directed repayment. Ellenbogen made additional, somewhat peripheral, complaints including an objection to the form of notice (a telephone call from a court clerk as opposed to an order) that she should repay her fee to the estate, that the court allowed payment of other claims of equal or lower priority while not allowing payment of her fee or Handelsman's fee, and that the court improperly based its decision on the marital relationship of Ellenbogen and her attorney. The court determined that all of her complaints were wholly without merit. In conclusion, the court stated that to do justice in this instance, and, on a larger scale, "to ensure the proper administration of guardianship and decedents' estates," to preserve the rights of the citizens of Pennsylvania, and to avoid significant harm to the beneficiaries and creditors of Pennsylvania estates, the court's decree on the "acutely important issue at the heart of this matter" should be "unreservedly" affirmed. *Humphreys Estate,* 25 Fid. Rep. 2d 394 (O.C. Alleg. 2004).

Volume 32, No. 1, Summer 2006

The ***ACTEC Journal*** (ISSN 1544-4945) is published quarterly for the Fellows of The American College of Trust and Estate Counsel as a professional service.

Members of the College receive a subscription to *ACTEC Journal* without charge. Nonmembers may subscribe to *ACTEC Journal* for $60 per year. Price for single issue, if available, is $15 per issue.

This publication contains articles that express various opinions. The opinions expressed in such articles are those of the authors and do not necessarily reflect the opinion of the College.

Correspondence with respect to College business may be addressed to Executive Director, The American College of Trust and Estate Counsel, 3415 S. Sepulveda Boulevard, Suite 330, Los Angeles, California 90034. Telephone: (310) 398-1888. Fax: (310) 572-7280.
Website: www.actec.org.