Report of the Flexible Income Trust Committee

State Bar of Georgia Fiduciary Law Section

July 10, 2002

Introduction

The Fiduciary Law Section of the State Bar of Georgia created a committee to study whether Georgia should adopt one or more of the legislative approaches that some other states have adopted to facilitate total return investing by trustees. The Committee has been referring to itself as the "Total Return Trust Committee," but that is a misnomer. Georgia already has adopted the "total return" approach to investments by trustees, which is based on Modern Portfolio Theory.

In appointing the Committee, leaders in the Section recognized the problem created for trustees trying to invest for "total return" and yet treat both income and remainder beneficiaries fairly in the traditional income trust. While the problems can be cured for future trusts by drafting, there are and will be many trusts that continue to use the traditional income and principal language, and statutory action seems appropriate. The Committee met in person on March 22, May 3, and June 21, 2002 and studied the two common statutory approaches adopted in other states: the discretionary power to adjust between income and principal as contained in the Uniform Principal and Income Act, and a statutory procedure to convert into a unitrust so that the amount of income to be distributed is computed as a percentage of the value of the trust assets. Both methods provide some flexibility in the definition of "income"; thus the name the Committee calls itself in this Report, the Flexible Income Trust Committee. Recognizing that neither approach is appropriate in every situation and that each approach has much to offer in certain circumstances, the Committee is recommending that the Section approve a new Georgia statute as set out in Appendix A to this Report. The statute as drafted generally follows the approach adopted in Pennsylvania, which affords a trustee discretion as set out in the UPIA unless the trustee (or the beneficiaries or a court) decides to opt into a unitrust regime.

Since the Committee began its work, many more states have adopted statutes, accelerated by the publication of proposed tax regulations in February of 2001 that would recognize either approach for tax purposes. In fact legislative action would now seem necessary in order to be able to benefit from the proposed regulations, which are expected to be finalized this year. Appendix B contains a list of states that have enacted or are considering stautes. The Committee will seek the approval of the Legislation Committee of the Section, then the Executive Committee of the Section and thereafter the Board of Governors of the State Bar of Georgia for introduction of such a statute to the Georgia Legislature in January, 2003.

There has been a great deal written on Modern Portfolio Theory, the Prudent Investor Rule, Unitrusts, the Uniform Principal and Income Act, and how all of those fit together. Appendix C contains a list of references generally, many of which are referred to in this Report by citation to the author's name.

The Committee members are: Chair, Donna G. Barwick, J.D.,CFP™ (The Arden Group), Timothy Agnew, C.P.A.,CFP™ (Smith & Howard), Stevie Casteel, J.D. (Powell, Goldstein), Nick Djuric, J.D. (Sutherland, Asbill & Brennan), Professors Anne Emanuel and Mary Radford (Georgia State Uiversity), Faryl Moss, J.D. (Faryl S. Moss & Associates), Jeff Scroggin, J.D. (Scroggin & Associates), Judge Susan Pierce Tate (Probate Court of Clarke County), Judge Louisa Abbot (Superior Court of Chatham County), Stanley Applebaum (Regions Bank), and Patricia D. Friedman, Esq. (The Bowden Law Firm).

Modern Portfolio Theory and Investing for Total Return

The Uniform Prudent Investor Act was adopted in 1994 by the National Conference of Commissioners on Uniform State Laws. The thrust of this Act is as follows: "A trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust." Uniform Principal & Income Act, section 2(b). In effect, the Act incorporates Modern Portfolio Theory.

The premise of Modern Portfolio Theory is based on the correlation of risk and return. In general, risk and return are directly correlated, i.e., the greater the risk, the greater the potential return, and the lower the risk, the lower the potential return. The goal of a trustee under the Act is to achieve an acceptable rate of return with the minimum level of risk.

Under Modern Portfolio Theory, diversification is essential to risk management, and so, as a general rule, the Uniform Prudent Investor Act requires a trustee to diversify a trust's investments. The trustee is therefore duty-bound to reduce risk through diversification without creating a significant negative impact on the portfolio's expected return. In other words, in selecting investments, the trustee should try to achieve greater return without increasing risk or decreased risk without reducing return.

The "prudent investor rule" replaced the "prudent man rule" for assessing a trustee's investment performance. Under the prudent investor standard, the trustee's performance is measured on the whole portfolio rather than on the asset-by-asset basis of the prudent man rule. Thus, the goal is acceptable return regardless of whether that return is in the form of accounting income or appreciation in principal. See the Spencer article at p. 8.

Georgia Code Section 53-12-287 embraces Modern Portfolio Theory in language similar to the Uniform Prudent Investor Act. Under that Code Section, a trustee is charged with exercising "the judgment and care, under the circumstances then prevailing, that a prudent person acting in a like capacity and familiar with such matters would use to attain the purposes of the account."

The remainder of O.C.G.A. Section 53-12-287 allows a trustee to consider general economic conditions, the anticipated tax consequences of the investments, the anticipated duration of the account, and the needs of the beneficiaries. Further, the propriety of an investment decision is to be determined by what the trustee knew or should have known about the inherent nature and expected performance of the investment (including probable yield), the attributes of the portfolio, the general economy, and the needs and objectives of the beneficiaries. Any determination of the liability for investment performance shall consider not only the performance of a particular investment but also the performance of the individual's portfolio as a whole.

In encouraging trustees to adopt Modern Portfolio Theory and to invest for total return, the Prudent Investor Act is completely indifferent as to whether the trustee generates dividends and interest (traditionally income) or appreciation (traditionally principal). Yet trustees traditionally have had a duty to produce a stream of income adequate for any beneficiaries entitled to it. And it is very clear that, notwithstanding the Prudent Investor Act, trustees remain under a duty of impartiality. Thus, if it turns out that the most appropriate mix of investments for a given trust consists largely of "growth stock" there may be little or no traditional "income" for the income beneficiaries. As a result, it appears quite possible that a trustee who fully complies with the central teaching of the Prudent Investor Act will also, in the same process, violate the duty to treat beneficiaries impartially. To the extent that this is so, a trustee may have a substantial incentive *not* to invest for total return, and the Prudent Investor Act may fail in its effort to improve a trustee's long-term investment performance. See the Ascher article at pp. 11-23.

In other words, the restriction on investments caused by a trust approach that requires distributions only of traditional trust acounting income is in direct conflict with Modern Portfolio Theory, which mandates investment for total return.

Historical Trust Design

Most trusts are designed to benefit more than one generation or set of beneficiaries. Classic trust design uses language that directs that income be paid to one set of beneficiaries (sometimes with invasions of principal limited to an ascertainable standard, such as health, education, support and maintenance) and the remaining principal paid to another set of beneficiaries.

This design places a trustee in a compromising position. Although an income beneficiary's needs may require the production of significant income, the trustee still has the responsibility to consider the remainder beneficiary's desire for growth of principal. These competing interests require different investment strategies. A portfolio that maximizes income (investment in bonds) makes the income beneficiary happy, but makes the remainder beneficiary unhappy. A portfolio that maximizes growth (investment in stocks) makes the remainder beneficiary happy, but makes the income beneficiary unhappy.

As an illustration of the competing interests, as of November 1999, 30-year Treasury notes yielded 6.16%. Average dividend yields from equities yielded 1.34%. A current income need of 5% after trustees' fees allocated to income would require 96.5% of the trust portfolio to be invested in fixed income and only 3.5% in stocks. See the Wolf and Leimberg 1999 article. Yet "most corporate fiduciaries are reluctant to invest less than one-half of their long-term trust portfolios in equity securities, simply because of the duty of impartiality and the historical truth that fixed income investments yield dramatically less in total return over long periods of time." See the Wolf article at p. 47.

This "middle of the road" approach typically results in insufficient income and mediocre and unsatisfactory capital appreciation. For example, with an even mix of stocks and bonds, one is currently able to generate only a net 3.16% return. See the 1998 Wolf article at p. 136. This amount is not enough to satisfy the income beneficiary nor is it likely to provide inflation protection for the income beneficiary or the remaindermen. Neither party is satisfied. This classic trust design creates a tension between all parties to the trust—the current beneficiary, the trustee and the remainder beneficiaries.

Unfortunately, income beneficiaries measure the performance of a trust based upon comparisons of current yield only. Typically, they compare their return with CDs or other fixed-income investments. Remaindermen, on the other hand, often compare the performance of the trust with the growth of the S&P 500. As a result, both income beneficiaries and remaindermen are often disappointed with the trust performance.
To satisfy the income needs of the classic income beneficiary, the trustee's only tool is asset allocation, which is also the factor that determines almost all of the investment total return. In the classic trust, the need for income "totally dominates the asset allocation policy" and results in the popular 60% equity and 40% fixed income mix in order to

provide a reasonable level of accounting income and potential for growth. But one flaw of this mix is that the stock portion of the portfolio cannot rise fast enough in a significantly inflationary environment to make up for its bond component – which does not offset inflation at all. The result is an approach that "cannot tolerate even modestly high inflation." See the Garland article at p. 53.

Most trusts are intended to last for more than one generation, yet with an emphasis on income, classic trust design does not take into consideration the long-term historical track record of stocks and bonds and the fact that the true inflation-adjusted long-term return from stocks is almost four times the return from bonds. Although investment in stocks clearly would increase the total return of the trust, because of the duty of a trustee to invest in part for the income beneficiary, total return is sacrificed. See the 1998 Wolf and Leimberg 1998 article at p. 4. R. In addition, classic trust design also does not take into consideration that the longer the investment horizon, the more likely common stocks will outperform other forms of investments. *Id.*

In today's market environment, and with the traditional income and principal distinction, the trustee can invest for income or for growth but not for both. For example, a $1 million trust invested entirely in the S&P 500 index would have a gross yield of $12,000. If only .35% of the trustees' fees is charged to income, the trustee will have no more than $8500 to distribute to the income beneficiary. After taxes, even at a modest rate, our new millionaire beneficiary will have about $500 per month or less to spend from our all-equity trust. And this is probably a best-case scenario in an all-equity trust. Many trustees allocate 50% or more of the trustees' fees to income. And trustees using equity mutual funds must charge all of the expenses to income, reducing gross income in many instances to zero for lower yielding equity mutual funds. See the 1998 Wolf and Leimberg article.

Conversely, if the trustee were to invest all in fixed income, in U.S. Treasuries, the gross income might be in the neighborhood of $55,000. But such a portfolio will produce absolutely no growth and a gradual erosion of the purchasing power of the trust principal and income due to inflation. A compromise between the two will be just that—a compromise of both income and growth goals. *Id.*

This is a relatively new problem. Prior to the late 1950s, dividend yields on stocks were always greater than the yields on bonds. In 1950 the yield on the S&P 500 was 8% while U.S. Treasury Notes yielded only 1.3%. Up to that time, there was merely the question of whether to incur greater risk in exchange for the potential of greater return. The markets and our trust instruments did not put the income and remainder beneficiaries at odds with the "income rule" trust. But for the last 40 years they have. *Id.*
Inflation, as a persistent long-term economic and investment factor, is also a relatively new concern for investment planners. It was in the latter half of the 1960s and thereafter, particularly the periods from 1973 to 1975 and 1978 to 1981, that forced investment planners to take inflation seriously. It was during this period of secular inflation that the concept of total return investing was born and flourished. Because of inflation, it is no longer sufficient to preserve the same nominal value in a trust and produce a sufficient

income stream. Rather, it is vital that investors maintain the real value of the principal and of the stream of income it produces. Studies of long-term return, both in principal value growth and in current income, show that only equity investments that represent an ownership interest in assets and income producing property kept pace with inflation. Thus, because investing in equities has increased in importance, while the dividends paid on equities have decreased substantially, the viability of the "income rule" trust is called into question. *Id.*

The Uniform Principal and Income Act

The Uniform Principal and Income Act, adopted in 1997 by the National Conference of Commissioners on Uniform State Laws (the "1997 Act"), gives a trustee the power to adjust between income and principal, in order to reflect new forms of investment and to reflect Modern Portfolio Theory.

Georgia currently has in place a trust principal and income statutory scheme that the state adopted, generally, from the Revised Uniform Principal and Income Act, promulgated in 1962 (the "1962 Act"). Under that Act: 1) the trustee shall first allocate principal and income in accordance with the terms of the trust, and 2) if there is no such direction in the trust, then the provisions of the Act control.

The relevant provision of Georgia's statute, which is similar to the 1962 Act, is O.C.G.A. Section 53-12-211(a), which concerns what controls the trustee's allocation of principal and income. Pursuant to O.C.G.A. Section 53-12-211(a): 1) the trustee shall first allocate principal and income in accordance with the terms of the trust, and 2) in the absence of contrary terms in the trust, in accordance with the provisions of Chapter 12 (the Georgia Trust Act), or 3) if neither of the preceding two rules are applicable, in accordance with what is reasonable and equitable in view of (A) the interests of income beneficiaries as well as of remainder beneficiaries; and (B) the manner in which a prudent person acting in a like capacity would act in the management of the property of another.

The 1997 Act made some significant changes to the 1962 Act, most importantly for the purpose of providing a means for implementing a transition to the portfolio theory of trust asset investment as outlined in the Uniform Prudent Investor ActSection 103(a) of the 1997 Act generally retains the priority listed above of the 1962 Act, but section 103(a)(4) of the 1997 Act directs the trustee to allocate a receipt to principal if the trust or the Act gives no direction as to its proper allocation. This is contrary to the 1962 Act, which gave the trustee the direction to allocate such a receipt in accordance with what is reasonable and equitable considering the beneficiaries' respective interests.

Section 103(b) provides that, in exercising a discretionary power to allocate the principal or income, a trustee shall act impartially, based on what is fair and reasonable to all of the beneficiaries, except to the extent that the terms of the trust clearly manifest an intention that the trustee favor one or more beneficiaries. The second reference based on the 1962 law and currently contained in O.C.G.A Section 53-12-211 to what a prudent person would do under like circumstances is removed in the 1997 version. The NCCUSL comments point out that there is no analogy there because most people do not think in terms of income and remainder beneficiaries except in the context of a trust.

Section 104 of the 1997 Act is the major provision dealing with the transition to Modern Portfolio Theory concerning the administration of trusts.

Section 104(a) provides: "A trustee may adjust between principal and income to the extent the trustee considers necessary if the trustee invests and manages trust assets as a prudent investor, the terms of the trust describe the amount that may or must be distributed to a beneficiary by referring to the trust's income, and the trustee determines, after applying the rules in Section 103(a), that the trustee is unable to comply with Section 103(b).

Section 104(b) of the 1997 Act follows with a list of factors that a trustee must consider in using the power to adjust. Section 104(c) of the 1997 Act provides particular circumstances under which a trustee may *not* use the power to adjust. One of these circumstances is if the trustee is a beneficiary. A trust may limit the power to adjust, but only if it is clear by the terms of the trust that the terms were intended to deny the trustee the power of adjustment. Section 104(f).

The 1997 Act further contains protection for trustees. Section 103(b) provides that a determination in accord with the 1997 Act is presumed to be fair and reasonable to all of the beneficiaries. Section 105 of the 1997 Act, which was added in 2000, provides that a court may not change a trustee's decision to exercise or not a discretionary power, unless the court finds that the trustee abused its discretion.

The proposed Georgia statute would adopt Sections 103 and 104 of the 1997 Act. These sections would apply to all trusts, unless specifically made inapplicable by the terms or the instrument or court decree. No action would be necessary for the power to adjust to apply to a particular trust. Once the power to adjust becomes effective, a trustee must review the trust periodically to determine if adjustments are in order.

Some commentators criticize the power to adjust as difficult to administer because the uniform rule has little specific guidance. Trustees may not want to take the chance or accept the continuing responsibility of exercising the discretion allowed by law; instead, many may prefer a rule that allows total return investing, without the constant need to take action that may be subject to parties' hindsight judgment. See the Leimberg and Gibbons article at p. 234. Indeed, concern over section 104 powers has held up adoption of the 1997 Act in some states, and in others, section 104 has been removed. See the Freedman article.

Despite these concerns, however, many states are following the model of sections 103 and 104 of the 1997 Uniform Principal and Income Act. The 1997 Act has been adopted in various forms by many jurisdictions, and is being considered for adoption by others. See Appendix A.

Unitrust Statutes

Several states have enacted statutes that would permit a trustee of an income trust to convert it to a unitrust, so that, after the conversion, the amount of "income" that must or may be distributed is defined as a percentage of the total assets of the trust. Such unitrusts resemble familiar charitable trusts in their terminology, but adopt that form of payout in a private family noncharitable context. For a discussion of these statutes, see the Wolf and Leimberg 2001 article. There was no uniform law project to use as a pattern for a unitrust stautue, and the New York committee spent years drafting the first one. The Georgia Committee has had the benefit of the hard work done in the states that have already drafted or adopted such statutes.

The main advantage of the unitrust format is that the focus is on total return, which, simply stated, is the investing of funds for maximum return, regardless of whether that return is in the form of accounting income or appreciation of principal. Total return benefits all the beneficiaries and aligns their interests. As the value of the trust increases, the current beneficiaries receive more income, so encouraging the use of an investment philosophy that strives for maximum after-tax returns and long-term capital growth. This investment strategy increases returns to the income and remainder beneficiaries and harmonizes the interests of both parties.

What is the appropriate payout percentage? Computer models suggest that in the long run, taking into consideration the long-term effect of taxes, costs, and inflation, a lower payout rate equates to higher growth and a more stable and smooth distribution level. An examination of 73 years of investment history and computer modeling with different trust payout rates suggest that a unitrust with a three year smoothing rule and a payout rate of between 3% and 5% works reasonably well if the trust is invested largely in equities. A higher payout rate can be used if the primary objective of the grantor is to favor the current beneficiary. A lower payout rate should be used where the grantor's primary goal is growth and the financial enrichment of the remainder beneficiaries is a priority. See the 1999 Wolf and Leimberg article.

Some commentators think that a payout of 4% or 5% is too high. Computer analysis, however, indicates that over the period from 1960 to 1994, with an all equity portfolio, a 4% payout yielded the highest after-tax income to the current beneficiary at the end of the period, which seems to strongly confirm a 4% payout is a feasible payout for an all-equity portfolio, but the longer the period, the lower the optimum rate. See the Wolf and Leimberg *1998* article at p.8.

The New York statute provides that the proper unitrust percentage is 4% and may not be changed by agreement or by the court. The proposed Georgia statute uses 4% as the default payout, but provides that the rate can be changed by a court if circumstances warrant.

The unitrust format has other advantages as well. Because both parties to the trust have aligned interests, the trustee and the investment professionals can be more focused. Asset allocation, based on the needs and risk tolerances of the beneficiaries, is restored to its proper place in investment planning. The risk is reduced that the trustee will be criticized by remainder beneficiaries who charge the trustee with investing too much of the trust's assets for income.

Likewise, the risk is reduced that the trustee will be sued by income beneficiaries who charge the trustee with investing too much of the trust's assets for long-term growth.
As David Diamond points out in his articleat p. 6, the goal of the typical settlor is not to create the perfect distribution rule (i.e., one that distributes only the real "income" to the current beneficiary and the real "principal" to the remaindermen), but simply to achieve a reasonable degree of fairness between the income beneficiary and the remainder beneficiaries. The unitrust model accomplishes this goal.

Because distributions for the entire year can be calculated at the beginning of each year, current beneficiaries can anticipate their cash flows more accurately and so engage in better financial planning.

The judicious sale of a sufficient amount of shares of an equity to supplement current yield in order to match the desired payout to the current beneficiaries results in more of each payment consisting of capital gains and non-taxable return of cost basis rather than ordinary income. This will reduce the current beneficiary's reportable income, increasing his or her after-tax spendable income, compared to the fully ordinary income payments from the classic trust.

Through a "smoothing" provision, which gives the beneficiary a fixed percentage of the market value of the trust on a fixed date, but averaged over a period of time, generally three years, a total return unitrust can dampen or eliminate the effects of temporary dips in the market and the consequent volatility of the amount paid to the current beneficiary from year to year. This provision will reduce the fluctuation in the distribution amount and aid the budgeting of the beneficiary and the cash flow projections of the trustee.

As with the New York statute, the proposed Georgia statute uses a three year smoothing rule.

By smoothly and automatically reducing the payout, the total return unitrust protects the trust from excessive damage in an extended bear market. As with a charitable remainder trust, the trust cannot be exhausted.

Of course, the unitrust form of payout may not be appropriate for every type of trust. As pointed in the Mark Edwards article at p. 11, four types come to mind:

A <u>credit shelter trust</u> where the surviving spouse is the beneficiary and is alive. Any mandatory distributions would remove assets form the shelter of the trust and subject any unspent portion to tax in the estate of the surviving spouse.

A <u>generation-skipping trust</u> that provides for distributions to a non-skip person for life and then to the skip beneficiaries. The mandatory unitrust formula would be contrary to good tax planning, for any unspent portion of the mandatory distributions to non-skip persons would be taxed earlier than necessary.

A <u>spendthrift trust</u> designed to protect assets from the claims of creditors. A mandatory unitrust interest would be reachable by creditors under the laws of most states.

A trust funded largely with <u>non-liquid assets</u> such as real property or closely held business interests. The unitrust formula might result in requiring payments in kind or requiring a forced sale of some of the assets.

Some commentators have pointed out that the terms of the unitrust require a payout from the trust even if the beneficiary does not need the money. First, because of the compressed income tax brackets applicable to trusts, all trust income over $8,900 is taxed at 39%. Distribution of these amounts to the beneficiaries generally results in a reduced income tax burden for the family group. And any funds not needed by the recipient could be removed from his or her estate through the use of annual exclusion gifts. Second, few beneficiaries are content to allow all income and gain to be accumulated in a trust, whether they "need" it. Given this aspect of human nature, the use of a unitrust payout imposes no real financial hardship on the trust or its beneficiaries. *Id.* at p.12.

Although it appears that the majority of commentators are in favor of the total return unitrust approach, Alvin Golden points out arguments against the routine use of unitrusts.

One is the lack of flexibility. In the income-principal formulation, the trustee can affect the returns to the current beneficiary through investment choices. In the unitrust scenario, the trustee is mandated to pay a fixed percentage of the value of the trust to the current beneficiary. This inflexibility could negate the proposed benefit of easing friction among classes of beneficiaries.

If the unitrust approach becomes the default drafting technique, the trustee's discretion in both the investment and distribution arenas is taken away. As the trustee is paid to be "in the middle," only a conscious decision should be made to remove discretion.

As mentioned above, many trusts have illiquid or difficult to value assets that will not adapt to a fixed percentage of value approach.

Difficulty of administration will still exist in that the trustee must be very careful to value the assets of the trust correctly. Further, the trustee must carefully monitor the trust and adjust investments so that the cash flow to pay the fixed distributions in a unitrust can be maintained without jeopardizing the future value of the trust. Since the distribution policy must drive the asset allocation, the trustee must consistently monitor the investments to assure the ability to meet the fixed requirements of a unitrust.

Golden also sets forth certain economic considerations that raise questions about the unitrust model based on a percent of value. In general, they are 1) projections typically use an assumed growth rate that does not reflect cyclical swings; 2) volatility in return increases as the portfolio holds a greater percent of equities and in a sustained drop, problems will invariably develop; 3) using a 60-40% model and taking into account administrative cost, taxes and inflation, a requirement to distribute all income will cause a real long term loss in value in the income stream and of the trust estate; imposing a 4% mandatory payout may cause the trust to lose enough value that it will expire during its term and prior to the termination date stated in the instrument, depending upon its net after tax return; and 4) there may be "excess" distributions of bond interest.
There are other accepted methods of allocating principal to an income beneficiary. For example, a trustee can use a discretionary power granted in the trust document.

The Proposed Tax Regulations

On February 15, 2001, the Internal Revenue Service issued proposed regulations (REG-106513-00, 66 F.R. 10396-10400 (2/15/01)) that revise the definition of income under I.R.C. section 643(b) to take into account changes in the definition of trust accounting income under state laws, in particular the equitable adjustment and unitrust models. The proposed regulations also clarify the situations in which capital gains are included in distributable net income (DNI) under I.R.C. section 643(a)(3). These proposed regulations remove a great deal of the uncertainty that surrounded the use of either a discretionary power to reallocate or a unitrust format and provide a blueprint for what a state statute should look like in order to be respected for tax purposes.

In general, the proposed regulations say that, "amounts allocated between income and principal pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year." This is exactly what both the 1997 Act and the unitrust statutes allow. The proposed regulations thus condone both of these new types of total return statutes.

Prop. Treas. Reg. 1.643(b)-1 provides that, for purposes of subparts A through D, part I, Subchapter J, Chapter 1 of the Code, the term "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 (that is, allocating ordinary income to income and capital gains to principal) will generally not be recognized.

The proposed regulations further provide that, nevertheless, amounts allocated between income and principal pursuant to applicable local law will be respected if local law provides for a "reasonable apportionment" between the income and remainder beneficiaries of the total return of the trust for the year, including ordinary income, capital gains, and appreciation.

In the unitrust context, there is a safe harbor for what is a "reasonable apportionment" of total return. Specifically, a state law that provides for the income beneficiary to receive each year a unitrust amount of between 3% and 5% of the annual fair market value of the trust assets is a reasonable apportionment of the total return of the trust.

The proposed regulations make clear that a state law that permits a trustee to make equitable adjustments between income and principal to fulfill a trustee's duty of impartiality between the income and remainder beneficiaries is generally a reasonable apportionment of the total return of the trust. These equitable adjustments are permitted when the trustee invests and manages the trust assets under the state's prudent investor standard, the trust describes the amount that shall or must be distributed to a beneficiary by referring to the trust's income, and the trustee after applying the state statutory rules regarding allocation of income and principal is unable to administer the trust impartially.

In addition, an allocation of capital gains to income will be respected if the allocation is made either pursuant to the terms of the governing instrument and local law, or pursuant to a reasonable and consistent exercise of a discretionary power granted to the fiduciary by local law or the governing instrument. In addition, if capital gains were utilized in determining the amount to be distributed to a beneficiary, they would be included in DNI. Prop. Reg. Section 1.643(a)-3(b).This insures that the tax wil be paid by the party who actually received the capital gains.

Under the new unitrust principal and income statutes, trustees will often use appreciated property to pay the required unitrust amount to current beneficiaries. The case of *Kenan v. Comm'r,* 114 F.2d 217 (2d Cir. 1940), held that a fiduciary's use of appreciated property to satisfy a beneficiary's right to receive a one-time distribution of a fixed-dollar amount was a realization event. And Rev. Rul. 67-74, 1967-1 C.B. 194, made it clear that a trustee would realize gain upon distribution of appreciated assets in satisfaction of a beneficiary's right to income. The proposed regulations codify *Kenan* and its progeny. Under the proposed regulations, capital gains would be included in DNI to the extent they are, under local law or the governing instrument, or pursuant to the reasonable and consistent exercise of discretion by the trustee: 1) allocated to income; 2) allocated to corpus but treated 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 utilized in determining the amount to be distributed to a beneficiary. Prop. Reg. section 1.643(a)-3(b).

To explain Prop. Reg. Section 1.643(a)-3, the Preamble to the proposed regulations indicates that capital gains are included in DNI if the following four possible circumstances:

(1)Any capital gain that is included in the section 643(b) definition of income;

(2)Any capital gain that is used to determine the amount or timing of a distribution to a beneficiary;

(3)Capital gains, if the fiduciary, pursuant to a discretionary power granted by local law or by the governing instrument (not inconsistent with local law), treats capital gains as distributed to a beneficiary, provided the power is exercised in a reasonable and consistent manner;

(4) If under the terms of the governing instrument or applicable local law, realized capital gains are treated as income to the extent the unitrust amount or the equitable adjustment amount exceeds ordinary income.

If a trustee intended to follow a regular practice of treating net capital gains as distributed to the current beneficiary and evidenced this practice by including capital gains in DNI on the fiduciary income tax return for the trust's first year, the trustee would have to follow this practice in all subsequent years. Conversely, if a trustee filed a fiduciary tax return not including capital gains as DNI, the trustee would have to use this practice thereafter. Prop. Reg. section 1.643(a)-3(e), Ex. 10 and Ex. 11. *Id.*

Although the proposed regulations include three examples that illustrate the tax treatment of unitrusts, they do not include an example illustrating the tax treatment of income paid pursuant to a power to adjust.

In his article, Richard Nenno explains how the proposed regulations likely affect state unitrust statutes generally:

> (1) Unitrust statutes with an ordering provision would enable the tustee to distribute capital gains to the current beneficiary;
>
> (2) It is not clear whether capital gain would be included in DNI pursuant to unitrust statutes that do not contain an ordering provision, and the trust does not include a provision giving the trustee discretion to allocate capital gain to income or DNI;
>
> (3) Commentators doubt that a trustee exercising the power to adjust under the 1997 Act would be able to distribute capital gains to the

> current beneficiary in most cases. Instead, it would be necessary for the instrument to give the trustee the discretion to allocate capital gains to income or DNI.

The proposed Georgia statute, in the unitrust conversion portion, contains an ordering provision.

The Need For A Statutory Framework and Court Proceedings

There has been much written about the benefits of a unitrust and why lawyers should be drafting most private trusts as unitrusts. Whether that is the case or not, there are many trusts already in existence, many form books using traditional income language, and many lawyers still drafting traditional income trusts. So, the trustees of those trusts will be struggling with how to invest for total return and treat the income and remainder beneficiaries fairly. And once the proposed tax regulations are finalized, the tax treatment of distributions under the two types of statutory solutions will be clear.

Where the trustee is granted total discretion, it is possible for a trustee to invest for total return because by definition the trustee has great flexibility in the decisions of what, when, and to whom to make distributions as well as the ability to vary the investment policy to the changing financial world and the circumstances and objectives of the family unit. Where there is discord in the family or with the decisions of the trustee, however, unbridled discretion in the trustee increases the potential for criticism, second-guessing, or family feuding.

Bill Hoisington, who was one of the earliest proponents of drafting private unitrusts, in his recent seminar paper observed that where trustees are given discretion, they basically administer trusts as though they were unitrusts – what he calls "virtual unitrusts." He did an informal survey of professional trustees and found that, depending upon the age of the income beneficiary, the trustee would make a judgment about the appropriate dollar amount of income, and then that amount would be converted into a percentage of asset value and thereafter that percentage of the market value would be distributed.

In two recently reported cases from Delaware involving trusts for the family of Henry S. McNeil, Sr. (founder of McNeil Laboratories, which was later acquired by Johnson & Johnson), the trustees were given extremely broad discretion to make distributions of income or principal among a group of family members. A schism in the family, complicated by less than adequate communication and other unfortunate behavior by the trustees, resulted in litigation over the trusts. One of the trusts had remained invested in a concentration of J&J stock with great overall performance, but low dividend yield, thus teeing up the textbook situation for a reallocation of principal to income at the request of a beneficiary. After struggling over a methodology to measure the appropriateness of large principal distributions to the requesting beneficiary, the trustees proposed a distribution policy based on a unitrust method, with no consideration of principal distributions beyond the unitrust amount. The Court approved of the unitrust concept and the propriety of that as a regular distribution policy, but would not approve the refusal to consider any further principal distributions, since that would allow fiduciaries the "use of such a general policy to evade their duty to make tough decisions." *Bishop v. McNeil,* 1999 Del Ch. LEXIS 186 (C.A. 15508) and *McNeil v. Bennett,* 2001 Del. Ch. LEXIS 91 (C.A. 15875).

The *McNeil* cases shed some light on how some of these trustee arrangements could be viewed by a court. Not only was there very broad discretion given to the trustees in that case, Mr. McNeil had further expressed his intent that the trustees be protected from liability unless they acted in bad faith or with gross neglect. As the court noted, that is usually the standard anyway when such broad discretion is given to trustees, but the court went out of its way to be mindful of that. The very existence of such broad discretion meant that just about anything that the trustees did could have been proper, but only if, "it resulted from a sufficiently informed and impartial decision-making process." The virtual unitrust approach might be one such method.

Where there is discretion given in the document as there was in *McNeil*, a Georgia trustee could presumably ask a Superior Court for a Declaratory Judgment under O.C.G.A. Section 9-4-4 to approve its distribution decisions. That section does require that there be a controversy, and in a *McNeil* type case there will be.

A fully discretionary trust is unacceptable to many people (and their lawyers) who do not have sufficient confidence in the trustee to vest that much power in the trustee. Therefore most trust documents provide for the payment of income to one beneficiary or set of beneficiaries with the remainder to others. Where discretion is granted to invade principal for one of the income beneficiaries, it is usually pursuant to specific standards such as support, health maintenance and education rather than a grant of complete discretion. Often the trustee is directed to take into consideration other means of support available to the beneficiary, which requires the trustee to collect information (usually regarded as an invasion of privacy by the beneficiary), and make judgmental decisions about the appropriate amount of any such principal distribution. Disputes over this type of discretionary decision would also seem to be an appropriate subject for a Declaratory Judgment action under current Georgia law.

Similarly, although the classification of a trust's receipts and expenses as principal or income is generally determined according to the applicable jurisdiction's principal and income act, a settlor may deviate from the statutory rules by directing a different allocation in the governing instrument or by granting the trustee discretion to decide. In Georgia, if the document incorporates the powers given to the trustee by reference to O.C.G.A Section 53-12-230, then the trustee does have discretion to allocate receipts and disbursements. Courts sometimes have held that language giving the trustee discretion to allocate receipts to principal or income grants the trustee absolute discretion without regard to the state's principal and income act. IIIA *Scott on Trusts*, 50-58 (Fourth Ed. 1988). When a trustee has complete discretion to allocate receipts to principal or income, a court may still place limits on the exercise of that power if the trustee abuses this power or does not use proper judgment. This, too, would seem appropriate for a Decalaratory Judgment.

Under current law, when there is no discretion given in a traditional income trust, the trustee is stuck between competing duties as discussed above. The proposed Georgia statute would adopt Section 104 of the Uniform Principal and Income Act giving all trustees the discretion to make adjustments between income and principal (which presumably goes further than initially allocating receipts) to achieve fairness while investing for total return. The comments accompanying the UPIA say that that section, "does not empower a trustee to increase or decrease the degree of beneficial enjoyment to which a beneficiary is entitled under the terms of the trust; rather, it authorizes the trustee to make adjustments to principal and income that may be necessary if the income component of a portfolio's total return is too small or too large…". As Hoisington points out, however, that determination of what is "too small or too large" still must be made by the trustee. These decisions will all be subject to court review.

There are many trusts where the trustee is also a beneficiary. That is one of the circumstances where Section 104 does not help, because such a trustee may not use the power to adjust. There are also trustees who would prefer not to have to revisit the discretionary distribution decision each year. Those situations cry out for the ability to opt into a unitrust regime, but there doesn't seem to be a good way to do that under current law.

O.C.G.A. Section 53-12-150 allows a *settlor* to expressly retain a power to modify the terms of a trust. For tax and creditor protection reasons, many *inter vivos* trusts do not do that. O.C.G.A. Section 53-12-153 allows a court to permit a trustee to modify the terms of a trust if it is established by clear and convincing evidence that, owing to circumstances not known to or anticipated by the settlor, compliance would defeat or substantially impair the accomplishment of the purposes of the trust. The comment to that section says that the use of this statute is limited to extraordinary circumstances. Would the dilemma posed by total return investing in a traditional income trust rise to the level of extraordinary circumstances?

In some states, an existing statute might provide a basis for converting an income trust to a unitrust. For example, in *Murphy Trust*, 20 Fid. Rep. 2d 46 (O.C. Mont. 1999), a Pennsylvania court considered a trustee's proposal to convert an income trust (which did not allow principal distributions) to a unitrust pursuant to section 6102(a) of the Probate, Estates and Fiduciaries Code. The court appointed a guardian ad litem who resisted the change on behalf of the unborn remainder beneficiaries and the court agreed with the guardian to deny the requested change. Mr. Nenno points out in his paper, that the appointment of a guardian-ad-litem makes it difficult for a trustee to successfully convert an existing trust. The proposed Georgia statute would give trustees a method to convert without court involvement if the requisite sui juris beneficiaries agreed. If anyone disagreed, the power to order a conversion would be given to a court.

The Georgia statute closely follows the new Pennsylvania law. That statute, however, seems to require that there be a beneficiary who objects, or that there not be in existence a current *sui juris* income or remainder beneficiary, in order to seek court approval of a unitrust conversion. The Georgia committee recognized that there may be some institutional trustees unwilling to convert to a unitrust without court approval under any circumstances and thus the proposed Georgia statute would make court approval an option in all cases. The committee discussed the balance between the desire to facilitate unitrust conversion and the cost and burden on the court involved in such proceedings. It was suggested that a settlor of a newly drafted trust could include a provision directing the trustee not to seek court approval, and at the same time, the practical reality of the cost relative to the benefit in a smaller trust situation might dissuade the parties from seeking court approval.

The question of which court should approve a conversion is complicated in Georgia. The Superior Courts have exclusive jurisdiction over equity cases under the Georgia Constitution. Ga. Const., Art. VI, Sec. IV, Par. I. Whether a proceeding to convert a trust to a unitrust or back again, or to request a different percentage payout or time frame for the smoothing rule or the like, is a matter of equity or administration is not entirely clear. Mr. Nenno points out that under the Delaware statute, such a conversion statute is expressly categorized as a matter of administration rather than construction. The Committee was uncomfortable arbitrarily categorizing such a proceeding as administrative and worried about the Constirtutionality of doing that in Georgia. It could be argued that the Probate Court would have jurisdiction if the trust was created in a Will under O.C.G.A. Section 15-9-30(a)(10), which provides that probate courts have "original, exclusive, and general jurisdiction" of "all…matters and things as appertain or relate to estates of deceased persons." That Section has been interpreted broadly to include a claim for breach of fiduciary duty by an executor in a case where the Georgia Court of Appeals described the probate court as, "the forum best suited to adjudicating such disputes…". *Heath v. Sims*, 242 Ga. App. 691 (Jan. 2000). It doesn't seem to make sense for jurisdiction to turn on whether the trust is testamentary or *inter vivos.* Following the line of reasoning of the best suited forum, it is apparently not uncommon for the Superior Court of Fulton County, upon request of the attorneys, to appoint the Probate Judge to hear certain cases where the issues would make that sensible. The Committee was not aware of whether such an appointment would occur outside of Fulton County, but following the same reasoning of the best suited forum, felt that the most desirable result would be to have such cases brought in the Superior Courts except in those Counties where the Probate Court has expanded jurisdiction. Thus the proposed statute refers to the Superior Court, but also would amend O.C.G.A. Section 15-9-127 to add unitrust conversions to the list of proceedings where those probate courts have concurrent jurisdiction.