

BOB WOLF'S TRU TUNE-UP

Our Thanks to Bob Wolf of Tener, Van Kirk, Wolf & Moore, P.C. in Pittsburgh, Pa.

Final Regulations Statutory Fine Tuning and Patches

In light of the issuance of the Final Regulations under Section 643 and related sections of the Code, it is absolutely clear that supporting state law is necessary for recognition of a unitrust as a trust which distributes “income” for a variety of purposes, including the Marital deduction, and to avoid the loss of grandfathering for Generation Skipping Transfer Tax Purposes, a possible gift or a sale or exchange in the case of a unitrust conversion. Because 17 states passed unitrust conversion statutes prior to the issuance of the Final Regulations, and more still passed the Uniform Principal and Income Act with the Power to Adjust, there are quite a few places where such statutes might be “fine-tuned” now that the Final Regulations are in effect. The state statutes vary quite a bit, so it isn’t possible to make too many generalizations, but there are a number of places where they might be revised to take advantage of the greater certainty produced by the Final Regulations.

The Power to Adjust

Consider eliminating the prohibition on the Power to Adjust against an adjustment which decreases income (from income to principal).

Consider eliminating the restriction against decreasing the actuarial interest of an income interest intended to qualify for the annual exclusion. It is not clear to me whether the exercise of the power to adjust would decrease the actuarial value of an income interest. It shouldn’t and the Final Regulations mention nothing about prohibiting downward adjustments to income interests for marital trusts or trusts intended to qualify for the annual exclusion. Of course the likelihood of a downward adjustment in income in order to treat the current and remainder beneficiaries impartially is fairly low presently, unless for some reason you had an all bond portfolio.

Could you eliminate the proscription against an interested trustee exercising the power to adjust? One could argue that you could based upon the power to adjust being a tax non-event under the Final Regulations. I don’t personally think that it is safe, since it could clearly increase the income beneficiary’s “take” and the standard for its exercise are not those safe harbored under the 2041 Regulations.

The Power to Convert to a Unitrust

Many of the statutes include a provision that require the distribution of the income or the unitrust amount, whichever is greater, in order to protect the marital deduction and the grandfathered status for GST purposes. It seems likely that those provisions could be eliminated. In certain markets, having a unitrust or income interest, whichever is greater may reintroduce the conflict between the interests of the current and future beneficiaries which it is the primary point of the unitrust to eliminate.

Consider the insertion of either a power in the trustee to determine when capital gains may be included in DNI for tax purposes, or an ordering provision taking out the accounting income first, then any other ordinary income, then short term capital gains, then long term capital gains, and then the principal of the trust. The Final Regulations seem to give fairly wide latitude to trustees in making a decision about this, but there are probably many states that do not have any clear law one way or the other granting the trustee the authority to consider payments from a trust to consist of certain classes of income in a particular order. Without something clear to point to, the drafter or the trustee may be restricted more than required by the Final Regulations.

Take a close look at the notice provisions for conversion. Many of our statutes leave out classes of beneficiaries who ought to receive notice. For example, our PA statute (we are fixing it) does not clearly require the next generation of beneficiary after the current beneficiary to receive notice, unless they are also the remaindermen, which is often not the case. For example, a trust for mother for life, and then to daughter, and then to grandchildren. The daughter may be inadvertently omitted, because she is neither a current beneficiary nor a beneficiary if the trust were to terminate now.

Perhaps the most important “patch” for unitrust states to consider is to clearly address the trust that is drafted as a unitrust, as opposed to one that is converted to a unitrust. I think it quite important that there be something in the statute that allows a drafter to create a unitrust without having to conform to the unitrust conversion provisions. Otherwise it is possible that an “express unitrust” might not be considered to be a trust distributing all of its income even where there is a conversion statute, because it is not following and pursuant to that statute. And it may often be the case that the drafter may wish provisions that are significantly different from the statutory provisions for a converted unitrust. A good example of this is where the statute grants the trustee the right to change the rate of the unitrust between 3 and 5%, such as in Delaware. A drafter may wish to choose a specific rate and not give the trustee the right to change it. The drafter may or may not want to give the trustee the right to change from the unitrust to an income trust. It is thus likely that it will be beneficial to have some short provisions that say this specifically.

I have provided three different versions of a proposed patch—one for states that have followed the Pennsylvania style statute, one for a Delaware style statute, and one for a state that has no unitrust conversion statute. The purpose for inserting it in a state statute where there is no conversion power is basically to give drafters more freedom. Otherwise, drafters in a non-unitrust state would not be able to use a unitrust for a marital trust without providing for the distribution of the income if greater distribution,

and in the case of a QDOT, not at all, and these are places where the unitrust may be particularly useful. Texas is the only state so far to have incorporated a unitrust definition of income in their statute without a conversion provision, but it seems likely that there will be more since it seems to have no downside. It simply increases the freedom of estate planners to use the unitrust where it may be helpful without disturbing (or increasing) the rights of any existing trust beneficiaries.

Pennsylvania Style Unitrust Statutes. § 8107. 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”:

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, regardless of whether the total return unitrust is created and governed by Section 8105 above or by the terms of the governing instrument.
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. 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 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.
7. 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 distribution exceeds the net accounting income, or it may specify the ordering of such classes of income.
8. 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 accounting income determined as if the trust were not a unitrust;

- (b) from ordinary income not allocable to net accounting 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.

Delaware Style Unitrust Statutes

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”:

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, regardless of whether the total return unitrust is created and governed by Section 3527 above or by the terms of the governing instrument.
3. An express total return unitrust may or may not provide a mechanism for changing the unitrust percentage similar to the mechanism provided under Section 3527(b) based upon the factors noted therein, and may or may not provide for a change from a unitrust to an income trust similar to the mechanism under Section 3527(b) above.
4. If an express total return unitrust does not specifically or by reference to Section 3527 grant a power to change the unitrust percentage or change to an income trust, then the trustee shall have no such power.
5. Such a distribution of the fixed percentage of not less than three percent nor more than five percent reasonably apportions the total return of a total return unitrust.

6. 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 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.

7. The trust document 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 distribution exceeds the net accounting income, or it may specify the ordering of such classes of income.

8. 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 accounting income determined as if the trust were not a unitrust;
- (2) from ordinary 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.

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.

States with No Unitrust Conversion Statute

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.

7. 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.

8. 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 accounting income determined as if the trust were not a unitrust;
- (b) from ordinary income not allocable to net accounting 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.

HOPE THIS HELPS YOU HELP OTHERS!

Bob Wolf

Tener, Van Kirk, Wolf & Moore, P.C.
920 Oliver Building
535 Smithfield Street
Pittsburgh, PA 15222
(412) 281-5580