

The New Income Clause

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The current buzz among trust and estates lawyers is about the ripple effects of our now not-so-new California adaptation of the *Uniform Prudent Investor Act*. (The Act)

The New Rules. The Act became effective in California January 1, 1996. It is found in a section dealing with the duties of California trustees (*Probate Code* /16046), and is also applied to nonprofit organizations under *The Uniform Management of Institutional Funds Act* (*Probate Code*/18506).

The standard of care under the Act is not based on risk alone, but rather on the appropriateness of the level of risk under all circumstances. Consistent with that, *The Restatement (Third) of Trusts (Prudent Investor Rule)* (1992), replicated virtually word for word in the California statute, flatly rejects case law and statutory approaches (often depression-influenced). Those approaches directly or indirectly resulted in restrictive lists of permissible investments, many of which provided levels of return so low that it was impossible to both generate substantial income and protect the corpus from inflation. The new statute is designed to instead to compel trustees to analyze thoughtfully the trade-offs between risks and returns, taking into consideration the needs and objectives of the trust. The trustee should then consciously choose the appropriate level of portfolio risk and anticipated return.

The Act also allows the trustee greater investment freedom than existed under prior law. For example, trustees were liable for portfolio losses even when the overall gains produced an acceptable total rate of return. Now, compliance with the new standards is judged as of the time an investment decision is made, not with the benefit of hindsight. That leads to reduced liability for trustees.

The Problem Presented. Under prior law, trustees generally used the ages and needs of income beneficiaries as a guide in structuring the trust portfolio. That is, if the income beneficiary was old, the portfolio was concentrated in bonds and mortgages, and if young, in common stocks. This did not always fit the needs of all income beneficiaries (a category which may include both young and old), did not always reflect the trustee's duty to meet the needs of remainder beneficiaries (those who become beneficiaries after the income interests expire) to keep asset value on par with inflationary erosion, and did not always reflect market conditions. As a result, the attempt to manipulate portfolio structure to meet beneficiary needs was often a compromise of the duties owed by the trustee to the various beneficiaries.

Under the Act, trustees are now told to *measure market risk* and to *take reasonable risks* in order to *enhance the total rate of return* without concern for how much of that return is classed as distributable income; *i.e.*, dividends and interest. Properly applied, this may present a serious

economic problem for income beneficiaries under trusts which are not updated to reflect this new reality. The trustee must carry out these fiduciary responsibilities by concentrating trust holdings in common stock during growth periods and in bonds and mortgages during flat or recessionary periods. This leads to under-recognition of income beneficiary needs during growth periods (because of low dividends on common stocks) and over-recognition of those same needs during flat or recessionary periods (because there is little or no capital gains retained and reinvested). Both come at the expense of the remainder beneficiaries.

Under trusts that are not updated to reflect this new economic reality, the trustee is usually given the power to invade principal in order to augment distributions to income beneficiaries. That may solve the problem during growth periods (although at the risk of remainder beneficiary lawsuits for overdoing the invasions). The trustee, however, being required to distribute all income, has no such latitude in *flat or recessionary* periods. For example, the trust usually provides for *all* net income to be distributed, and the portfolio is then held primarily in fixed investments due to market conditions. The result is that there is little or no equity growth to offset inflation -- the principal interest of the remainder beneficiaries -- while income beneficiaries receive generous distributions.

The Answer. *The answer is to tie the income distributions to portfolio value so as to maintain an adequate stream of distributions to income beneficiaries, while protecting remainder beneficiaries from the inroads of inflation.*

Following are the provisions I have prepared and recommend for use in various parts of the living trust in most popular use, the marital deduction-qualified terminal interest property trust.

While Both Spouses Live. The usual provision during this stage of life is one in which the trustee is directed to accumulate income and distributed only what the husband and wife (the persons who created the trust) direct. Upon the incapacity of one spouse, the other may give those directions. Upon the incapacity of both, the trustee is required to get involved, to determine their needs, and to *deal* with them. As a consequence, the Act presents no problem at this stage.

At the First Death. Upon the death of either spouse, the trust divides (for ultimate tax avoidance reasons) into three sub-trusts. Two are irrevocable and hold the interests of the deceased spouse, while the interests of the surviving spouse continue under the same rules as before (including the right to amend or revoke). Here are the considerations as to each of these sub-trusts:

– **The Survivor's Trust.** While the trust may provide for income distributions in whatever amount is generated by the portfolio, it also gives the surviving spouse the power to take out whatever he or she pleases (a general power of appointment). At first blush, this seems to deal nicely with the problem, after all, it's his or her money and this is maximum flexibility. But what if that surviving spouse loses legal capacity? The power to take out whatever he or she pleases is frozen in place on loss of capacity, because that spouse is no longer competent to exercise the power.

The answer is to switch to a new regime. Specifically, to accumulate income and distribute in the discretion of the trustee. That both covers expenses and avoids accumulations of cash outside the trust. It might set up like this:

E. The following provisions apply to the *Survivor's Trust*.

(1) The net income shall be paid in monthly or other convenient installments to or for the benefit of the surviving Settlor for life.

(2) There is hereby reserved to the surviving Settlor a general power of appointment over the principal and any accrued and undistributed net income of the *Survivor's Trust*, which power may be exercised at any time after the establishment of such trust or upon the death of the surviving Settlor. Such power shall be exercised only by a written instrument other than a Will on file with Trustee at the office where the Trust is being administered.

(3) If, in the opinion of Trustee, the surviving Settlor becomes incapacitated, or is for any reason unable to exercise the general power of appointment, then Trustee may pay to or apply for the benefit of the surviving Settlor so much of the income and principal as Trustee in its sole and absolute discretion deems necessary for the reasonable care, support and maintenance of that Settlor. Any income not so applied or distributed shall be added to principal.

— **The Exemption Trust.** This is an irrevocable sub-trust holding property of the deceased spouse equal in value to the amount passing free of federal estate tax. In modest estates, the income is paid to the surviving spouse for life, then held, managed and distributed to or for the children. In larger estates (where the surviving spouse may not have a need for the income), the trust income may be accumulated and distributed to the survivor at the discretion of the trustee, and otherwise held for later distribution to or for the children. The latter form takes care of the problem presented by the Act, so here is a provision that works for those trusts in which the surviving spouse needs or wants the income:

(1) Trustee shall add income to principal and from the common fund shall pay to the surviving Settlor a sum equal to 4% of the Trust Estate's value as that value existed on the last day of the preceding calendar year, minimum \$[] for the first full calendar year if the *Exemption Trust* did not then exist. Said distribution shall be characterized as *income* for tax and trust accounting purposes, and shall be paid one-twelfth monthly or in other convenient installments for the remaining lifetime of said surviving Settlor. Such payments may be made to or for the benefit of said surviving Settlor in accord with the provisions of Section 9E.

(2) If, in the opinion of Trustee, the surviving Settlor becomes incapacitated, then Trustee may pay to or apply for the benefit of the surviving Settlor so much of the income and principal as Trustee in its sole and absolute discretion deems necessary for the reasonable care, support and maintenance of that Settlor. Any income not so applied or distributed shall be added to principal.

– **The QTIP Trust.** This is an irrevocable sub-trust holding property of the deceased spouse equal in value to the *excess* over the amount passing free of federal estate tax. It is drafted so as to allow a marital deduction (thus estate tax deferral) if that proves of value at the first death. The governing code provision is *IRC/2056(b)(7)*. It deals with it being ...treated as passing to the surviving spouse... and ...from the decedent... and a qualifying interest for life... and defines that qualifying interest for life as: the surviving spouse is entitled to *all the income* from the property, payable annually or at more frequent intervals, or has a usufruct interest for life in the property; and no person has a power to appoint any part of the property to any person other than the surviving spouse. (Emphasis added.)

Usufruct means treat it like you own it; *e.g.*, the residence. So, to protect the marital deduction, something must be added to the QTIP trust income provision so as to be certain that all income (in the trust accounting sense) is actually distributed.

Beyond that, the options are more limited. Not only must we make certain that income (as that term is defined in trust accounting law), is distributed, but nothing can change on loss of capacity; otherwise, the ability to take the marital deduction is lost in the first instance. Therefore, if the surviving spouse loses capacity, and if the income distributions exceed his or her support needs, and if there is no one holding a legally sufficient power of attorney for property, a *conservator* must be appointed to collect the income, pay the expenses and account annually to the court. With that caveat, the issue presented by the Act may be addressed with an income distribution provision along the following lines:

G. The following provisions shall apply to the *QTIP Trust*:

(1) Trustee shall add income to principal and from the common fund shall pay to the said surviving Settlor a sum equal to *the greater of* 4% per year of the QTIP Trust value as that value existed on the last day of the preceding calendar year, or the *actual* Trust accounting income for that preceding year if the QTIP Trust was in existence for the full period; provided, however, that any such trust accounting income in excess of the 4% standard shall first be applied to any shortfall for years in which actual income was less than that standard.

As to the first year in which the QTIP Trust is established, the amount payable shall be the greater of 4% of the QTIP Trust value as that value existed on the date of death of the predeceased Settlor, with adjustments for actual accounting income as described above applied in subsequent years.

All such distributions shall be characterized as *income* for tax and trust accounting purposes and shall be paid (and deemed earned) one-twelfth monthly or in other convenient installments for the remaining lifetime of said surviving Settlor. Any income so computed which is accrued and unpaid on the death of the surviving Settlor shall go and be distributed as provided at Section 6G(2) below. Any distributions in excess of the amount so computed shall be charged to principal.

If, in the opinion of Trustee, the surviving Settlor becomes incapacitated, then Trustee may pay to or apply for the benefit of the surviving Settlor so much of the income and principal as Trustee in its sole and absolute discretion deems necessary for the reasonable care, support and maintenance of that Settlor. Any income not so applied or distributed shall be accumulated; provided, however, that all such accumulated income remaining at the death of the surviving Settlor shall then be distributed. to the Survivor s Trust.

Any and all such income distributions may be made to or for the benefit of the surviving Settlor in accord with the provisions of Section 9E.

On Death of the Surviving Spouse. Where income is provided for life to one or more beneficiaries, the new income provision sets up like this:

(1) Trustee shall add income to principal and from the common fund shall pay to the said [child/beneficiary] a sum equal to 4% of the share value as that value existed on the last day of the preceding calendar year, minimum \$[] if the share did not then exist. Said distribution shall be characterized as *income* for tax and trust accounting purposes, and shall be paid one-twelfth monthly or in other convenient installments for the remaining lifetime of said [child/beneficiary]. Such payments may be made to or for the benefit of said [child/beneficiary], in accord with the provisions of Section 9E.

Conclusion. The remedial provisions described above have the effect (except during the joint lifetime of the spouses) of converting the trust accounting model from simple to complex. That, however, is a matter for the tax accounting professional. The problem addressed is much more important.

As to the power of the drafter to define principal and income items in the ways here presented, both case law and the new California adaptation of the *Uniform Principal and Income Act* provide much latitude, as well as deference to *bona fide* decisions of the trustee concerning the discretions involved.

As you can see, the law changes periodically. You should, therefore, make it a point to review your estate plan from time to time; it enables you to be certain that your objectives remain obtainable, and to exploit every useful new opportunity.