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Prop. Regs. on the Definition of Trust Income: The Best Thing for Life Insurance Planning Since Sliced Bread!

When in mid-February the IRS issued REG-106513-00,[1] the Proposed Regulation on the definition of trust income under Section 643, it's possible that some insurance professionals (and perhaps a number of attorneys, CPAs, and financial planners) didn't make the connection between the incredible implications of this revolutionary new interpretation and their own future.

Some advisors may have seen this development as an unimportant, ho-hum, highly technical fix that is of interest only to academics, legal scholars, CPAs, and those who must file trust income tax returns. It's easy to understand *why some practitioners might fail* to bridge the gap; the tax law definition of trust income seems to be both esoteric and horrifically complex—and as far removed from life insurance (or even estate) planning as any topic could be.

The goal of our commentary is to dispel that misconception. To those who can distinguish between trains and lights at the end of a tunnel, this IRS Regulation signals a very significant event. With the investment of a few minutes of patience and careful reading, you'll find that not only is there an extremely important nexus which *every* financial services professional must grasp, but there is also a very large, important, and consumer-oriented life insurance need that the new definition leads to—almost inevitably.

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Purpose of the Proposed Regulations

The purpose of the new rules is to keep pace with state law changes in the way trust accounting income[2] is defined. The changes are intended to strike a balance: On one hand, the new definitions allow trustees to implement a total return investment strategy and follow the applicable state statutes designed to treat income and remainder beneficiaries impartially. On the other hand, the new Proposed Regs. are intended to protect against "gaming the system" by assuring that a trustee does not have unlimited and unfettered ability to allocate between income and principal.

The importance of understanding why the IRS made this change. The IRS recognizes that the current Code definition of income has not kept pace with changes in the way money is currently invested and the way income is currently defined under state law. Under many states' laws, dividends and interest were considered income. Therefore, these items were typically allocated only to the income beneficiary. Capital gains, on the other hand, were almost universally allocated to a trust's principal.

But with the advent of the TRU[3] (or *Total Return UniTrust*) concept, many states have revised, are about to revise, or are considering revising their traditional concepts of income and principal. TRUs have become more and more popular in recent years because of changes in the types of available investments and in investment philosophies.

Impact of the Prudent Investor Rule. Many states have enacted—in one form or another—the Prudent Investor Rule. This law changed the standards for managing trust assets by encouraging fiduciaries to adopt an investment

strategy designed to maximize the total return on trust assets. Key to understanding this concept is that total return means maximum return regardless of whether that is defined as accounting income *or* principal. This investment philosophy is the source of the impetus for creating new trusts as TRUs or converting existing trusts into TRUs. The reason this investment strategy is so popular is that it makes good investment sense in today's world. Under this strategy, trust assets are invested for total positive return (ordinary income *plus* appreciation) to maximize the overall value of the trust—for *both* income and remainder beneficiaries.

Avoiding the natural diametric opposition

Think about it. A great majority of trusts in existence today provide: "Income to my spouse for life, then to my children." These are called "principal and income" trusts. The trustee holds and preserves the trust's capital and pays out its income. However, many such principal and income trusts drafted today are not only less than effective in promoting family harmony and maximizing family financial security, but are actually counterproductive and in some cases harmful.

Total return investing basically attempts to move away from the old principal and income paradigm in which the income beneficiary seeks the highest income-producing investment possible (e.g., buy bonds), while the remainder beneficiary encourages the trustee to purchase the highest growth investment available (e.g., purchase equities). This traditional manner of investing trust assets puts the surviving parent and the children immediately and eternally at odds, and places the trustee in the middle of an insolvable continuing investment conflict. The result pleases no one and makes it almost impossible to achieve the highest possible overall return on the trust's investments.

The total return approach suggests that equities, rather than bonds, should comprise a much larger percentage of trust assets than under traditional investment standards. But of course, even if it were prudent investing to do so, few trustees would invest either totally in income-producing assets (e.g., bonds) or totally in growth assets (e.g., stocks) because of the trustee's duty of impartiality to the two different classes of beneficiaries—income and remaindermen. But just to make a point, let's run the numbers anyway.

The first problem that occurs when investing mainly in equities is their relatively low income yield, which in recent years has dropped precipitously—to about 1.2% (S&P 500 average). So each "unit" of $1 million of stocks in a trust would produce approximately $12,000. That's *before* taxes, trustee's fees, brokerage costs, etc. The impact of such an all- or almost-all-equity investment on the income beneficiary (typically, the surviving spouse) would be dramatic and adverse under the traditional trust model. Again, the reason is that, under the *traditional* concepts of income and principal, the income beneficiary is entitled only to the dividends and interest earned by the trust assets.

Bonds currently produce an average of roughly 5.8%. So investing the entire trust portfolio (say, one "unit" of $1 million) in bonds would generate about $58,000 annually. Again, that's *before* taxes, trustee's fees, brokerage costs, etc. Investing the entire trust portfolio in bonds is not the answer because (1) bonds provide no opportunity for growth, (2) such an investment would totally ignore the realities and lessons of the modern portfolio theory, and (3) such an investment would violate a trustee's duty of impartiality.

The "Solomon" ("cut the baby in half") approach is typically not much more viable than investing completely in stocks or completely in bonds. To illustrate, assume that the trustee of a trust with $1 million of assets purchased $500,000 in bonds and $500,000 in stocks. Under this scenario, the average income produced would be [(1.2% + 5.8%)/2] 3.5%. The $35,000 of pre-tax income produced would certainly not be sufficient for the income beneficiary in most cases, nor would the appreciation on the $500,000 of stock make up for the fact that there would be no growth in the bond portion of the portfolio. In attempting to make both classes of beneficiaries happy, the trustee has succeeded in pleasing (or appropriately investing for) neither.

The TRU approach. One potential solution to this dilemma is to adopt the familiar and time-tested CRUT (charitable remainder unitrust) model, and use it in the

[1] REG-106513-00, 66 F.R. 10396-10402 (2/15/01).

[2] Generally, the term "income" (for certain trust taxation purposes) means the amount of income of the trust or estate determined under the terms of the governing instrument and applicable local law. See Section 643(b). To prevent "games," the Regulations have long provided that trust provisions that depart fundamentally from the concepts of local law in determining what constitutes income will not be recognized. See Reg. 1.643(b)-1.

[3] See the articles and extensive citations on TRUs by Bob Wolf, Mark Edwards, David Diamond, Michel Nelson, Patti Spenser, Jim Dam, and others at http://www.leimberg.com and in the archives of http://www.leimbergservices.com.

private sector. In other words, a trust is drafted to provide that the surviving spouse in our examples above will receive—not all the income produced by the trust—but rather a fixed percentage of the value of the assets in the trust, as valued from year to year (a three-year "smoothing" formula is common to minimize volatile fluctuations). For example, if the "pie" is worth $1 million in year 1 and the grantor's surviving spouse is to receive 5% of that pie, she'd receive $50,000. If the pie grew to $2 million in year 2, she'd still receive the same 5%, but now the trust's payment to her would be $100,000 (i.e., 5% of $2 million).

This, of course, is an oversimplified explanation. There are infinite varieties of TRUs,[4] and in many cases the proper approach will often be to use a combination of TRU and discretionary or other type of trust.

Why the change in federal law

When this TRU concept was reported by *The Wall Street Journal*,[5] RIA,[6] *Forbes*, Standard & Poor's, *Bloomberg Personal Finance*, *Medical Economics*, and at the *Miami Estate Planning Institute*,[7] the proverbial cat was out of the bag. As eminent speakers and authors throughout the country (such as those already noted) and luminaries William L. Hoisington, Anne Hilker, Jerry Horn, Pam Schneider, Robert Freedman, Noel Ice, Robert J. Rosepink, Bill Ensing, Frank Croak, Alvin Golden, Dan Rottenberg, and others began to lecture or write about the TRU concept and explain it to legal, accounting, trust, and financial planning groups who then shared the idea with existing trust clients as well as perspective clients, the experts were in turn asked if existing trusts could be converted into TRUs.[8]

Many states[9]—to ensure that the income beneficiary will not be penalized if a trustee adopts a total return investment strategy—already have made, or are considering making, enabling revisions to their definitions of income and principal. Clearly, REG-106513-00[10] will provide significant impetus to accelerate the adoption of such laws. The Treasury now fully and clearly recognizes this movement, and the Proposed Regulations are the Service's very positive, timely, and helpful reaction.

Equitable adjustment between income and principal

To assure that both the income and remainder beneficiaries are treated impartially, some of the recently revised state laws allow a trustee to make an "equitable adjustment" between income and principal. These adjustments are based on "what is fair and reasonable to all of the beneficiaries." To accomplish this equitable adjustment and treat both parties impartially, a trustee might pay out to the income beneficiary capital gains (which would have been allocated to principal if there had been no change in state law). Another

[4] See the articles at http://www.leimberg.com and in the archives of http://www.leimbergservices.com referenced in note 3 *supra*.

[5] See Asinof, "Estates and Trusts: A Special Summary and Forecast of Federal and State Developments," The Wall Street Journal, 9/16/98, p. A1.

[6] Wolf and Leimberg, "Total Return Unitrust: The (TRU) Shape of Things to Come," 23 Est. Planner's Alert 6 (Dec 1998).

[7] Wolf and Leimberg, "Case Study—Total Return Trusts: Techniques and Applications," 34 *U. Miami Heckerling Inst. on Est. Plan.* (Jan 2000), and Wolf, Leimberg, and Porter, "The Total Return Trust (TRU) Revolution—An Introduction," 34 *U. Miami Heckerling Inst. on Est. Plan.* (Jan 2000).

[8] Note to those who previously dismissed TRUs with the thought that TRUs could easily be replaced by giving the surviving spouse—or a trustee—a discretionary power: Such a right often results in the same "tug of war" between income beneficiary and remainderman that existed in old style trusts. This type of power may be a useful escape valve but isn't a dependable, predicable rule allowing all the parties to plan, and may thwart—rather than support—the objectives of the grantor. Such powers give trustees no direction or guidance as to how to invest or exercise discretion nor do beneficiaries have any basis for planning. It is also essential for planners to understand that TRUs and discretionary powers are different tools designed for different purposes and that—if desired or desirable—neither TRUs nor discretionary powers need be an either/or choice or a mutually exclusive decision. For instance, it is quite possible to establish a TRU with a low payout rate, say 2%, and then give the trustee and/or one or more beneficiaries the power to invade principal under an ascertainable standard for up to specified amounts.

[9] A total of 13 states have adopted the new Uniform Principal and Income Act with the Power to Adjust between Principal and Income (with eight introductions in 2001). Four states (New York (Bill Form), Missouri (Bill Form), Pennsylvania (Bill Form expected within several months), and Delaware (Bill Form expected this year)) are close to enacting legislation to allow a unitrust definition of income as an additional alternative to the power to adjust.

[10] These proposed rules would apply to trusts and estates for taxable years that begin on or after the date that final Regulations are published in the Federal Register.

example of a reallocation to achieve impartiality would be for the trustee to allocate dividends or interest (which might otherwise have been allocated to the income beneficiary) to the principal beneficiaries (i.e., to the remainder beneficiaries).

The TRU approach. The equitable allocation approach described above has the disadvantage that trustees (for many reasons) may not want to take the chance or accept the continuing responsibility of exercising the discretion allowed by law. Many would prefer a "rule" that allows them to invest for total return yet without the constant need to take an action that may be subject to both parties' hindsight judgment (as well as a court's).

So some states' legislation would allow the trustee to pay a unitrust amount to the income beneficiary in satisfaction of that beneficiary's right to the income from the trust. This unitrust amount will be a fixed percentage of the trust's assets as redetermined annually. As we noted above, the TRU model is very much like the CRUT—except that in this case, there is no charity involved and there are none of the harsh and restrictive requirements that CRUTs must meet. State law will generally set ranges of allowable fixed percentage payout rates.

The new Proposed Regulations

The roadblocks that existed before the Prop. Regs. were released. Practitioners who considered creating TRUs, or who contemplated converting existing trusts, asked the IRS how these state statutory changes would affect the federal tax laws that require a definition of income. Specifically, with respect to marital trusts, practitioners such as E. James Gamble (at that time, President of the American College of Trust and Estate Counsel) asked if a marital trust would qualify for the marital deduction under Section 2056 (i.e., whether the spouse would be considered to be entitled to all the income from the property in a state that permits equitable adjustments or unitrust payments). Practitioners have also asked whether an otherwise GST tax-exempt trust that uses equitable adjustments or unitrust payments will become subject to GST tax provisions.

Reponse of the Prop. Regs. Under the Proposed Regulations, the term "income" will be redefined to take into account Harry Markowitz's modern portfolio theory and the move toward TRUs. As under prior rules, the Proposed Regulations will continue to provide that "trust provisions that depart fundamentally from traditional concepts of income and principal (that is, allocating ordinary income to income and capital gains to principal) will generally continue to be disregarded." But reasonable allocations will be respected. According to the Prop. Regs., amounts allocated between income and principal pursuant to applicable state law will be respected—if state law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, taking into account ordinary income, capital gains, and, in some situations, unrealized appreciation.

The Proposed Regulations make clear that "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."[11] Interestingly, this is amazingly close to Bob Wolf's "target" suggestion[12] of 3.5% to 4.5% payouts. Wolf, who has done extensive modeling of TRUs and is developing trust modeling and analysis software in this area, suggests that the estate planning team consider using different payout (Wolf calls them "spending") rates in different circumstances—not only to match different risk tolerances but also to achieve different planning objectives.

For instance, rather than establishing the payout rate of a client's marital and nonmarital trusts at 3.5%, it might be more effective to structure the spending rate in the marital trust at 5% (to enable the surviving spouse to receive and spend down more, thus exposing a smaller amount to estate tax at her death), while the spending rate in the same client's nonmarital (by-pass) trust might be set at 2% (to enhance the buildup and passing of wealth estate tax-free to the next generation). Wolf's computer modeling has shown that the lower the payout (spending) rate, the safer and more certain the future income stream (and not coincidentally the growth of capital). This has the additional advantage of lowering the risk that must be taken in the trust's investments to achieve a given level of income. (Of course, the more capital in the trust, the lower the risk that must be taken to achieve a particular income level.) More conservative individuals may opt for a combination of TRU with a low payout rate and a discretionary power in a trustee to make up the difference in needs in specified circumstances. An infinite

[11] See Prop. Reg. 1.643(b)-1.

[12] See Bob Wolf's articles on TRUs at http://www.leimberg.com.

variety of combinations and permutations is possible.

Prop. Reg. 1.643(b)-1 also provides that "a state law that permits the trustee to make equitable 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." Even an allocation of capital gains to the income beneficiary will be respected, if the allocation is directed by the terms of the governing instrument and applicable local law. Similarly, if a trustee, operating under a discretionary power granted to the trustee by local law or by the governing instrument (if not inconsistent with local law), allocates capital gains to income, the allocation will be respected, provided that the power is exercised in a reasonable and consistent manner.

Issue of marital deduction trusts solved. In order for a transfer to qualify for the estate tax marital deduction, it must meet certain requirements under Section 2056. One of the main requirements when a transfer is in trust is that the beneficiary-spouse must be entitled—for life—to *all the income* from the trust property. In a nutshell, the spouse must—in essence—have a life estate. But will this test be met in the case of a TRU or similar arrangement?

According to the Proposed Regulations, a spouse's interest *will* satisfy the income standard if the spouse is entitled to income as defined under a state statute 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 Prop. Reg. 1.643(b)-1. Reasonable apportionment can be accomplished through a unitrust definition of income or by giving the trustee the power to make equitable adjustments between income and principal. A similar rule will apply to QDOTs (qualified domestic trusts).

Impact on GST tax-exempt trusts. Many clients have GST tax-exempt trusts—those trusts that were irrevocable on 9/25/85. Practitioners, mindful of the fact that the exemption from GST tax is lost if a GST transfer is made out of corpus added to the trust after that date, were concerned about the impact of modifications to such trusts. So the question is: Will conformance with a change in state law cause such a trust to lose its exempt or grandfathered status? Planners wondered if such changes would fall within the safe harbor for modifications that do not shift a beneficial interest in the trust to a lower generation beneficiary or increase the amount of a GST transfer.

The Proposed Regulation answers that question affirmatively. The Prop. Regs. provide that the administration of a pre-9/25/85 trust in conformance with a state law that defines income as a unitrust amount, or permits equitable adjustments between income and principal to ensure impartiality, and that meets the requirements of Prop. Reg. 1.643(b)-1 will *not* be treated as a modification that shifts a beneficial interest to a lower generation beneficiary, or increases the amount of a generation-skipping transfer.[13]

To summarize, the Treasury has acted unusually quickly and extremely positively. Through the Proposed Regulations, the Service has placed its blessing on both the power to adjust and the unitrust, and in doing so, is providing guidance precisely when it is needed, rather than after guidance has been needed for a long time. The Service stated, "The proposed changes to the regulations will permit trustees to implement a total return investment strategy and to follow the applicable state statutes designed to treat the income and remainder beneficiaries impartially."[14] The Proposed Regs.:

- Bless a state law unitrust interest and a principal and income act with the power to adjust as qualifying for the gift and estate tax marital deduction. A conforming change is made in the QDOT Regulations.

[13] See Prop. Reg. 26.2601-1(b)(4)(i)(D)(2).

[14] Preamble to the Proposed Regulations, 66 F.R. at 10397.

- Permit the use of an ordering rule by the governing instrument or by state law, which includes short- and long-term capital gains in distributable net income (DNI).
- Allow a trust that was GST grandfathered to retain its GST tax-exempt status where such trust is converted to a unitrust pursuant to a state statute which defines income as a unitrust amount or which permits equitable adjustments between income and principal.

The difficulty of matching realities to expectations

It may be trite—but it's certainly true—that the economic expectations of our clients and their families are higher than ever before. Along with those higher expectations come higher income needs. Yet the realities of the "income needed-income available" computation have seldom been realistically analyzed in the trust context. To put it bluntly, when was the last time an attorney drafting a trust asked a client how much income his/her spouse/family *needed*—and compared that with a realistic assessment of how much *net* income the trust he/she was drafting would *actually* produce?

Why this is all so very important to the life insurance community

Having read this far, readers have (hopefully) concluded that there is a desirability—if not an absolute ethical and professional necessity—to compare several types or models of trusts with respect to each trust's ability to achieve a client's financial and "people" objectives as well as tax goals. With the future of federal estate taxes (and therefore the sale of life insurance to provide liquidity for most larger estates) currently much in doubt, it is interesting, encouraging, and even exciting to observe that the Treasury is one of the first—rather than one of the last—to adapt sensibly to new investment realities and clear the way for more effective trust planning. This gives the informed insurance advisor yet one more way to add value to the client's estate planning process, and the entire planning process can now focus more on financial and human needs than on estate taxes.

Of course, none of this suggests that the TRU, in any of its permutations, is *the* trust for all seasons or the *only* trust that should be considered.[15] This analysis *does*, however, strongly suggest that all planners are under an obligation to their clients to consider (if only to weigh the pros and cons and then discard) TRUs. And it *does* force us *all* to recognize that there is more than one planning paradigm, particularly the now outmoded one that ignores the importance of evaluating the survivors' needs—and comparing expectations with reality—before drafting a trust. In fact, failure to consider the TRU concept and compare it with viable alternatives may well be a negligence trap for both the trustee and the trustee's professional advisors. The insurance specialist who brings the TRU concept to the attention of the client and the client's other advisors has therefore done a favor to both.

But where, you may be asking, does the enhanced need for life insurance come in? As a by-product of his computer modeling studies to compare various trust models, Bob Wolf found that almost no attorneys and few banks or trust companies were able to illustrate to clients how much income would be provided—after income taxes, trustee's fees, brokerage costs, and accounting expenses. In other words, for each $1 million "unit" that is contributed to a trust (no matter what type of trust it is), most professionals could not show and the clients could not ascertain how much real spendable income would be produced using given "what-if" scenarios.

Most attorneys considered "the perfect trust" as one that successfully accomplished tax objectives. They never tested the trust's ability to meet the "people" and family financial security goals of the client. Few advisors ever asked, "How much income does your spouse need?" "How much capital will be needed—and when will it be needed—for events such as private school, college, graduate, or post-graduate school?" Prior to Wolf's (and others') investigation into the viability of the TRU concept through sophisticated modeling software, most professionals would not have considered using computer modeling to test the viability of achieving specific goals or to test the ability of the client's capital inside the trust to generate the necessary income.

Although reality-based planning through computer modeling is an indirect by-product of the move toward TRUs, it may well be

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[15] For instance, a TRU is typically contra-indicated for a spendthrift trust because a required payout can be reached by creditors. Nor is a TRU indicated when a trust is to be funded primarily with real property or a closely held business interest because the mandatory payout might require a partial liquidation if the income stream produced is insufficient, and an annual valuation of real estate or closely held stock tends to be costly. And generally, TRUs are not indicated for most generation-skipping trusts because providing for mandatory payouts to nonskip persons for life and then the remainder to skip persons would result in taxing the unspent portions of the amounts paid out earlier than otherwise necessary. Finally, TRUs are not usually indicated if it is certain or likely that the trust will end in a relatively short time, because the important advantages of a TRU typically increase the longer the trust lasts.

one of the most important outcomes. Now, the following three levels of inquiry must be made by all the members of the planning team:

- What type of trust(s) or combination of trusts must be drafted to best meet the client's personal, financial, and tax objectives?
- Is there sufficient capital in that trust to actually meet the client's expectations?
- If capital is insufficient (even after the most appropriate type of trust or combination of trusts have been drafted), what is the best way to make up the shortfall?

The long-term implications of the new Proposed Regulations must be understood and should not be underestimated by any estate planning attorney, CPA, trust officer, life insurance agent, or financial planner! If a "unit" (say, $1 million) of capital in a trust realistically produces only $X of net spendable income, how many units must be placed in the trust to generate sufficient income? Is there a shortfall between the client's standard of living or other income expectations and the net income that will likely be produced by the trust? If so, how best can more units of capital be placed in the trust? And how can the grantor-client make it possible for the trustee to afford to take less risk with the trust's principal and still achieve the same level of after-tax income flow? The answer will quite often be the addition of more capital—through life insurance.

Conclusion

This analysis of capital needs is not a new concept. But it now must be considered by the entire planning team, especially in the light of multi-disciplinary practice. The repeal/reform of the estate tax coupled with the enhancement of trust flexibility (made possible by state and federal acceptance of the TRU concept and the ability to computer model realistic assumptions and alternative scenarios) will place a spotlight on the "expectation-reality" syndrome—i.e., there is all too often a gap between what the client (and the client's family) wants and expects and what is likely to actually happen. Quite often the logical conclusion will be that, in order to match client expectations with reality, an infusion of additional life insurance will be necessary.[16] ■

[16] There are, of course, alternatives. One is to depend on greater risk-taking to make up for the capital that should be there—but isn't. Another option is for the surviving family to invade capital—probably to the long-term detriment of both the income and remainder beneficiaries—to make up for the income shortage. Yet a third alternative is to lower family expectations (or be prepared to reduce the survivor's standard of living) to a more realistic level.