

## OUTSIDE COUNSEL

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*The Unitrust Approach to Calculating Income*

In a column published on March 5, we commented on the enactment of the Uniform Principal and Income Act, EPTL 11-A-1, including the unitrust approach to calculating income, a critical step to enabling New York trustees to fully adopt the Prudent Investor Standard and its adherence to modern portfolio theory.

The Prudent Investor Act, EPTL 11-2.3, became law in New York in 1995. Previously, we laid out the major points of modern portfolio theory: its focus on total portfolio return; the selection of assets in order to optimize return for a given level of risk; and the ways in which it can assist fiduciaries in better balancing the needs of both income and remainder beneficiaries.

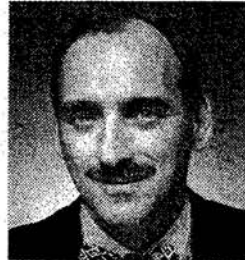
We also pointed out, however, that trustees' efforts to manage trust assets for total return were stymied by their inability to treat appreciation as income for the purposes of making distributions to income beneficiaries. The adoption of the Uniform Principal and Income Act, including the unitrust approach to defining income, was the necessary next step in the implementation of modern portfolio theory for New York fiduciaries. This article focuses on issues relating to the unitrust approach to the calculation of income.

### Unitrust Statute

Effective Jan. 1, 2002, EPTL 11-2.4 (entitled the Optional Unitrust Provision and hereafter called the unitrust statute) provides a definition of income for trust purposes that avoids entirely the need to classify increases of value as either principal or income by allowing trustees to utilize a unitrust approach to income equal to 4 percent of the net fair market value of principal held in the trust on the first business day of the current valuation year.

The unitrust statute is accessed in any of three ways. First, the governing instrument may direct the use of the unitrust definition.<sup>1</sup> Second, upon consent of all parties interested in the trust to the use of the unitrust approach, it may be elected.<sup>2</sup> Third, a petition may be submitted to the court having jurisdiction over the trust seeking application of the unitrust definition.<sup>3</sup>

The right to petition is drafted in the alternative. A petitioner may seek to have the unitrust approach apply or not apply, and instead seek to apply the Uniform Principal and Income Act to the definition of income per EPTL



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11-A.1.<sup>4</sup> Thus, a change from one method of income calculation to the other is theoretically possible. Whether the petitioner seeks to have the unitrust statute apply or not apply, the court in ruling on the request must consider a series of factors, as follows:

1. The nature, purpose and expected duration of the trust;
2. The intent of the creator of the trust;
3. The identity and circumstances of the beneficiaries;
4. The need for liquidity, regularity of payment, and preservation and appreciation of capital; and
5. The assets held in the trust; the extent to which they consist of financial assets, interests in closely held enterprises, tangible and intangible personal property, real property; the extent to which the asset is used by a beneficiary and whether an asset was purchased by the trustee or received by the creator of the trust.<sup>5</sup>

### First Case

The first case under the new unitrust statute has now been decided in *Matter of Ives* in Broome County.<sup>6</sup>

In the case, the decedent left a will in which he created a credit shelter trust for the primary benefit of his surviving spouse. The trustee had discretion to pay income and principal. The spouse petitioned under the unitrust statute to convert her income interest to a 4 percent unitrust.

As one might expect, the returns to the spouse were lower at 2 percent to 3 percent, so application of the statute would provide an increase.

Factors one and two were addressed by the petitioner in the form of an affidavit from the attorney draftsman of the will stating that the primary purpose of the trust was to maximize estate tax savings and to provide for the spouse. (A convenient affidavit to be able to include.)

The court also determined the purpose of the trust from the language of the instrument that allowed principal invasion for the support and maintenance of the spouse in the standard to which she is accustomed.

Factor three was addressed by affidavits from the remaindermen to the effect that they were otherwise provided for and that the unitrust conversion would not adversely affect them. (Whether such cooperation would always be forthcoming is another matter.)

The spouse included her affidavit with a budget attached showing current income distribution to be insufficient to meet her financial needs. The trustee did not appear in the proceeding so it seems unlikely the trustee objected to the conversion to a unitrust and perhaps points out the preference to seek court approval rather

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than simply proceed upon the consent of all the interested parties as the statute permits. The process would be streamlined by simply filing the consents with the court and thus obviating the need for a decision.<sup>7</sup>

Factor five was covered when the court noted that the trust assets were made up of marketable securities that would allow for an increase in payout under the unitrust method without an adverse affect on the mix of trust assets.

The fourth factor and particularly "the preservation and appreciation of capital" aspect was probably addressed when the court noted the primary intent of the testator to provide for his spouse.

The foregoing highlights the usefulness of documenting the intent of a testator, especially if the draftsman is not available at the time such a petition is brought.

### Timing Question

As noted above, the effective date of the unitrust statute was Jan. 1, 2002, and it specifically provides guidance for trusts in existence prior to the effective date in connection with filing consents to adopt the unitrust approach.<sup>8</sup> The question thus arises whether or not one who

brings on a petition for application of the unitrust statute may seek an effective date for the trust revision for years before Jan. 1, 2002.

One might so conclude based upon EPTL 11-2.4(e)(4), which states in part "this section shall apply to a trust ... as of the first year of the trust in which assets first become subject to the trust." The court in *Ives* provided an answer to this question in the negative noting that the statute goes on to say that this is the rule unless the court "provides otherwise in its decision."

The court noted in "providing otherwise" that to allow application to the first year assets became subject to the trust would require a recalculation of income for prior tax years and the attendant amendment of income tax returns. The decision can be read as one in which the court simply provided otherwise in its decision but it goes further by explaining that application of the unitrust approach to years prior to the petition was only intended "prospectively" or in the future.

So, for instance, in situations where the petition is brought for a new trust that may not have been funded at the time of the petition the calculation of income would be applied prospectively to income

returns to be received after the date of the petition. The *Ives* court held that it is "unfair to both the income and remainder beneficiaries to compute payout on investment standards that were not in effect at the time the investments were made ... it is equally unfair to base any standard of trustee performance upon laws that were not in effect at the time of the trustee's actions."

### Smoothing Rule

For these reasons and others mentioned below, the decision may be read by some as holding that the statute has no application to trust years before Jan. 1, 2002. An examination of the rest of the decision with respect to application of the "smoothing rule" could support such an interpretation but other courts may disagree for reasons set forth below.

By way of background, in the first three years of a trust subject to the unitrust statute, income is defined as 4 percent of the net fair market value of assets held in the trust as of the first business day of the current evaluation year. Thereafter, a smoothing rule is applied to calculate the unitrust amount.<sup>9</sup>

The application of the smoothing rule raised two issues for the *Ives* court. Does the smoothing rule apply to trust years before Jan. 1, 2002? Does the smoothing rule apply in year three or four?

In *Ives*, the trust was apparently first funded in 2000 so from a purely numerical perspective the first three trust years were 2000, 2001 and 2002. The smoothing rule states that "commencing with the fourth year of the trust" the unitrust amount (4 percent) is multiplied by a fraction the numerator of which is sum of each prior valuation year and the denominator of which is three.<sup>9</sup>

The court holds in *Ives* that for purposes of the smoothing rule, years before the effective date of the unitrust statute cannot be considered. Without more, the application of the statute would seem to dictate that the smoothing rule would first apply in 2005 because 2005 would be the fourth numerical year of the trust.<sup>10</sup>

The surrogate finds, however, that the fourth year of the trust is 2004. The court duly notes that the purpose of the smoothing rule was to average three years income for purposes of calculating the unitrust amount and therefore finds a conflict in the statutory language in that the smoothing rule is supposed to average three years but begins in the fourth? The court thus holds that "the smoothing

rule was intended to be a three year average consisting of the current valuation year and two prior years."

### Concluding Example

An example would be helpful: Suppose a trust is funded in year one with \$100,000 and principal increases by \$100,000 each year for the next three years, and suppose alternatively that principal decreases by \$100,000 in each year. In a rising market, beginning the smoothing in year three instead of year four will result in \$4,000 less income distributed in year three than if the smoothing begins in year four.

Conversely, if the smoothing begins in year three instead of year four in a falling market beginning smoothing in year three will result in \$4,000 more income being paid out to the income beneficiary.

In making the calculation note that EPTL 11-2.4(c)(3) defines prior valuation year as each of the two years of the trust immediately preceding the current valuation year. Income payouts are significantly different depending on which approach to the smoothing rule is selected and whether the market is rising or falling.

The application of the smoothing rule only to years after 2002 supports the interpretation that the statute can only apply after the effective date. The prudent investor standard, however, was adopted in 1995 so perhaps others will argue that the statute should be applied prior to 2002 since the unitrust aspect was only designed to facilitate the prudent investor standard which has been in existence, and of which trustees have been aware, for over seven years. It will be interesting to see if other decisions reach different conclusions.

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(1) EPTL 11-2.4(e)(1)(A)  
(2) EPTL 11-2.4(e)(1)(B) as to trusts in existence prior to Jan. 1, 2002, if by Dec. 21, 2002, such consent is obtained and as to trusts in existence after Jan. 1, 2002, if before the last day of the second full year of the trust such consents are obtained.  
(3) EPTL 11-2.4(e)(2)(A) & (B)  
(4) EPTL 11-2.4(e)(2)(A) and (B).  
(5) EPTL 11-2.4(e)(5)(A)  
(6) *Matter of Edward J. Ives*, NYLJ July 29, 2002, p. 28, Col. 3, Broome County, Peckham, J.  
(7) EPTL 11-2.4(e)(1)(A) and note that the election on consent must be filed with the court and presumably the court could sua sponte request a hearing on the matter or exercise jurisdiction in such manner as it deemed necessary.  
(8) EPTL 11-2.4(e)(1)(B)  
(9) EPTL 11-2.4(b)(1)  
(10) The decision in *Ives* specifically excludes application to petitions brought for trusts more than three years after 2002 when application of the smoothing rule according to the court may not be an issue.