Report of the Chair

By NED DONOGHUE
DECHERT

As I approach the end of “my year” as Chair, I think back on the meaning of it. Our goal is to improve the administration of justice in our area of the law and to help improve how probate law is practiced for the Section members. I feel confident we have well fulfilled our mission in 2002.

Through the work of many, many hardworking and dedicated Section members I have had the chance to see that process at work and maybe nudge it forward a little and to offer thanks and recognition to those who have done it. All in all, an experience I have thoroughly enjoyed.

Now, as we approach the year’s end, I just want to take this opportunity to wish all the Section members and all the others who supported our efforts Happy Holidays and a safe and peaceful New Year!

Inside this Issue...

Interview with Judge Herron.................................................................3
Working with Pennsylvania’s New Principal and Income Act..............4
The Pennsylvania Principal and Income Act: Comparisons with Similar State Laws and Aspects of Trustee Responsibility...............9
The Final Minimum Distribution Regulations: Selected Changes.................................................................14
Section 529 Plans and Uniform Transfers to Minors Act.....................15
Ethics Column..................................................................................17
Tax Update.......................................................................................19
Section Events Calendar.................................................................26
Philadelphia Estate Planning Council Calendar of Events...............27
Trust in Teamwork

There's no substitute for the security of knowing that your financial interests are being managed by a professional team that understands your goals and is committed to responsive, individualized service.

Working together, we work with you.
As trustee, executor, guardian or advisor, our Trust team will map a strategy, pursue your objectives and safeguard your wealth.
Our combination of fiduciary skills and investment sophistication relieve you of the burdens of managing wealth today while preserving it for future generations.

The Pennsylvania Trust Company.
Teamwork you can trust.

To discuss your objectives, please call Kathleen F. Freed at 610.975.4300
Five Radnor Corporate Center Suite 450 Radnor, PA 19087 www.penntrust.com
An Interview with Judge John W. Herron

By MARY JANE BARRETT, ESQUIRE
HARKINS AND HARKINS

John W. Herron has come full circle professionally, returning to the Orphans’ Court as a jurist some 30 years after he was sent there as a greenhorn. It seems that when he was a young associate at White and Williams, his colleague, Pete (now Judge) Drayer, dispatched him to the call of the audit list on a certain wintry morning with a hand-up. The entire seven judge court was assembled, and John W. Herron, in front of a crowded court room, rushed in to hand up the audit papers without removing his overcoat. To the bemusement of the onlookers, he was summarily “dressed down” by Judge Charles Klein for being thus overdressed, and exhibiting rank discourtesy to the court in failing to hang up his coat. The stature and respect of the Orphans’ Court demanded no less.

Though as a judge he does not believe in formality for formality’s sake, Judge Herron knows how to run a court room and administer a caseload. His journey to the bench began with an undergraduate degree from Duke University and a law degree, with honors, from the Dickinson School of Law. He brings to the court a broad array of experience, ranging from private practice, to assistant district attorney, to Chief Disciplinary Counsel for the Pennsylvania Disciplinary Board, to Deputy District Attorney for investigations. Elected to the bench in 1987 and retained in 1997, he has held several assignments in the criminal and civil divisions. He served as Administrative Judge of the Trial Division for the period January, 1996 to February, 2002, supervising 70 trial judges and approximately 1,000 court employees. A “can do” administrator, he worked to modernize and streamline the civil complaint, motion and discovery processes, organized judicial teams for case management, halved the civil jury trial backlog and initiated numerous other administrative accomplishments, all while handling a full judicial caseload.

He is particularly proud of his role in creating the Commerce Court, which handles complex commercial litigation, and affords litigants a reasonable alternative to the federal district court for the resolution of business disputes. Commerce Court is a direct product of Judge Herron’s judicial philosophy in action, which is to promote the just, speedy and inexpensive administration of justice. Not afraid of hard work or written analysis, Judge Herron authored over 30 opinions in Commerce Court in one year. He sees striking parallels between Commerce Court and Orphans’ Court, where specialization is fostered, practitioners tend to possess greater skill, and the bar is both cohesive and congenial.

Judge Herron is particularly pleased to be on the Orphans’ Court and to be able to work closely again with Administrative Judge Joseph O’Keefe. He noted, with a combination of humor and irony, that they have exchanged roles as Administrative Judge; while he once supervised Judge O’Keefe in the trial division, he now calls him boss in the orphans’ court division. Judge Herron spends long hours behind his desk in Room 300, City Hall, which he dubs his prison. His confinement is softened, however, by the portrait of his handsome 17 year old son, Davis, which graces his credenza. A sailboat screen saver is also there to remind him that, all things considered, he’d rather be presiding as captain of his boat on the Chesapeake.

Though only a part of the Orphans’ Court for about four months, Judge Herron was thoughtful about some of its quirks and historical differences, pondering the cumbersome attachment process as an example. He thoroughly approves of the case management initiatives of the recent past and is looking forward to the continuing modernization of the court, including the possible introduction of electronic filing. He is already the veteran of over 50 guardianship hearings, and is concerned with selecting guardians who will foster the welfare of the incapacitated person. Working from an individual calendar—so different from the wholesale volume of motions and fragmented matters that flow through the civil division—allows Judge Herron to give additional attention to the cases before him and to craft careful decisions.

When asked to comment on the apparent demise of career Orphans’ Court judges such as Judge Klein, Judge Herron mused both about the judiciary in general and the orphans’ court in particular. An unabashed advocate of merit selection,
Working with Pennsylvania’s New Principal and Income Act

By ROBERT L. FREEDMAN
DECHERT

Pennsylvania has adopted a comprehensive Principal and Income Act effective July 15, 2002 to supersede the former antiquated and fragmentary statute. This article discusses the new law and describes what trustees will need to do as a result of its enactment.

The new law follows the Uniform Principal and Income Act (1997) with certain changes. Aside from the changes, it is to be interpreted to promote uniformity among the states.1

Overview

The new law can be thought of as having three separate parts.

The first part contains the detailed rules about what is income and what is principal. These rules are found in PEF Code §§8121-8167.

1 PEF Code §8191.

2 PEF Code §§8103(b) and 8104(a)(2). The Pennsylvania drafters’ comment states that the “impartiality standard . . . does not require that the trustee treat the income beneficiary and the remainder beneficiary equally, because most creators of trusts intend the trustee to favor those generationally closest to them.”

Interview with Judge Herron, continued

Judge Herron expressed dismay over the lack of experience and qualifications of some judicial candidates. Judge Herron places blame on judicial salaries, which often deter those with family obligations from leaving private practice, and the rigors of the political process. He noted with resignation the difficulty of an experienced orphans’ court lawyer getting elected to the court, and, if successful, then getting assigned to the orphans’ court division. On the other hand, he felt that the system of periodic rotation of judges can bring innovation and breadth of experience to the court. He admits that there is a learning curve involved, but feels that by throwing oneself into it, a dedicated judge can master the work.

It is clear that with Judge Herron’s energy, intellect and amiability, he will complement the team of Judges O’Keefe and Lazarus, and help spur the already palpable resurgence of the Philadelphia Orphans’ Court to the stature of years gone by. Judge Klein would surely approve.

its own may simply take some income and call it principal, or take some principal and call it income, in order to achieve a fair and reasonable result.

The third part of the new Principal and Income Act concerns the ability of a trustee to renounce the power to adjust and to convert a trust into a total return unitrust. This ability is not found in the Uniform Principal and Income Act, but is similar to recent provisions in Delaware, New York and elsewhere. Trustees will need to consider whether they should convert to a unitrust.

The Act contains provisions to protect trustees from liability in connection with exercising the power to adjust and the power to convert to a unitrust. It also provides that certain insubstantial allocations to income need not be made.3

The Act may be overridden by contrary provisions in the governing instrument.4 For example, if a trust instrument directs that bond premiums be amortized, the trustee must do so even though the Act has a different rule. Accordingly, trustees should review the principal and income allocation provisions in their trust instruments. If the trust instrument gives the trustee discretion to allocate, the trustee nevertheless must administer the

3 PEF Code §8148.
4 PEF Code §8103(a)(1).

continued on page 5
Principal and Income Act, continued

trust "impartially based on what is fair and reasonable to all of the beneficiaries, except to the extent that the governing instrument clearly manifests an intention that the fiduciary shall or may favor one or more of the beneficiaries.""

The Detailed Rules as to What is Income and What is Principal

The detailed rules apply to receipts and disbursements occurring after July 15, 2002, even if the trust was created and was irrevocable prior to that date.

These detailed rules are found in PEF Code §§8121-8167.

The first thing trustees must do is get themselves internally organized so that when receipts come in or disbursements are made they know whether to allocate them to principal or income under the detailed rules. They will also have to be internally organized to handle apportionments at the end of a life estate.

One way to understand these detailed rules is to examine a typical trust from its inception to its end and see what the rules say. This may be a bit tedious, but it is less tedious than simply reciting the rules themselves.

Accordingly, let us consider a decedent who dies and whose will creates a trust to pay the income to a life tenant, and on the life tenant’s death to pay the principal to a remainder beneficiary.

In settling the decedent’s estate, the detailed rules are found in PEF Code §§8121 and 8122. They provide:

1. Specific legatees receive the income from the specific property bequeathed to them.

2. Pecuniary legatees receive interest in accordance with present Pennsylvania law found in PEF Code §§3543 and 7187. The Uniform Act gives pecuniary legacies in trust a share of the estate’s income; Pennsylvania rejected that approach in favor of retaining our present law.

3. The decedent’s debts, funeral expenses, the family exemption, executors’ fees, legal and accounting fees, and death taxes and related interest and penalties are all allocated against principal. Note that interest on death taxes is payable from principal. The Uniform Act would have given the fiduciary discretion to pay administration expenses and interest on death taxes from income or principal, partly to allow a match up with how these expenses are treated for tax purposes. Pennsylvania rejected this approach in favor of following the usual rules subject to the power to adjust contained in PEF Code §8104.

4. If there is more than one residuary beneficiary, income is allocated among them on a fractional basis.

In our case the estate is now over and the assets are distributed to the trust under the will. The income interest of the life tenant is deemed to begin on the date of the testator’s death. Apportionments depend on the “due date” of an item. Income receipts and disbursements having a due date prior to the date of the decedent’s death are allocated to principal. Income receipts and disbursements having a due date on or after the date of the decedent’s death are allocated to income. This means that periodic receipts such as rents, dividends, interest and annuities, and disbursements such as the interest portion of a mortgage, are not apportioned. Income receipts or disbursements having non-periodic due dates, or no due date, are treated as accruing from day to day. Thus, income tax refunds and other receipts not having a due date are apportioned, principal receiving the portion accruing before death.

Now the trust is up and running. Between the date the trust is actually created and the date the trust actually ends, the detailed rules in PEF Code §§8141-8151 tell the trustee how to allocate receipts between income and principal. Among other things, these detailed rules provide:

1. Reinvested cash dividends are allocated to income. The Uniform Act allocates them to principal but states that, if this is a trustee’s continuing practice, principal should reimburse income.

2. Short term and long term capital gains from mutual funds are allocated to principal. The

---

\(^{9}\) PEF Code §8131(b)(2).

\(^{10}\) PEF Code §8132.

\(^{11}\) PEF Code §8141(a).

\(^{12}\) PEF Code §8141(b)(4).

---

continued on page 6
Principal and Income Act, continued

Uniform Act follows the Internal Revenue Code model in allocating short term capital gains from mutual funds to income.

3. Money received, to the extent the paying entity indicates it is a partial liquidation or is greater than 20% of the entity’s gross assets, is allocated to principal.13

4. The proceeds from the sale or redemption of a debt instrument purchased at a discount are allocated to principal, unless the obligation, when acquired, has a maturity of less than one year.14 The power to adjust may be useful if a large portion of a trust’s assets consists of zero coupon bonds.

5. An operating business may be accounted for separately and special rules apply.15

6. Interest income is allocated to income without regard to amortizing premiums.16

7. IRAs and other retirement benefits are generally looked through as if they were a separate trust.17 If the trustee can “readily” ascertain the income within the retirement fund, distributions from the fund up to this amount are income.

If the trustee cannot readily ascertain the internal income of a fund, 10% of distributions from the fund is income. The Uniform Act has only the 10% rule. The power to adjust was created originally in large part to cover this situation.

8. Ten percent of receipts from patents, copyrights, and certain similar items are income.18 Again, the power to adjust may be important if these assets constitute a large portion of a trust’s assets.

9. There are further rules regarding rental property, obligations to pay money, insurance policies, liquidating assets, natural resources, property not productive of income, derivatives and options, and asset-backed securities.19

The rules regarding the allocation of disbursements are contained in PEF Code §§ 8161-8167. Essentially, they depart from the Uniform Act (which has a number of mandatory rules) and follow present Pennsylvania practice of giving the trustee wide discretion in allocating disbursements between income and principal. The trustee, in its discretion, can allocate between income and principal ordinary expenses incurred in the administration, management or preservation of the trust property, including the compensation of the trustee, the investment advisor, the custodian and the tax return preparer.20

However, certain disbursements must be paid from income.21

These include interest (other than interest on death taxes), ordinary repairs, real estate and other regularly recurring taxes assessed against principal, and recurring premiums on fire or other insurance covering the loss of a principal asset or income from the principal asset.

Certain other disbursements must be allocated against principal.22 These include extraordinary expenses incurred in connection with the administration, management or preservation of trust property and the distribution of income, extraordinary repairs, legal fees, expenses in connection with accountings and judicial proceedings, payments on the principal of trust debt, premiums paid on a life insurance policy of which the trust is the owner and the beneficiary, death taxes, including interest and penalties, and disbursements related to environmental matters.

Detailed rules cover depreciation,23 taxes attributable to subchapter S corporations,24 and adjustments to compensate for tax effects.25

Now let us suppose the life tenant dies. His estate is not entitled to the income due or accrued, but only to the net income received before his death.26 This means, for example, that if a periodic payment of rent that is due on July 20 has not been paid when the life tenant dies on July 30, the late paid rent is allocated to principal. The next rental payment, due August 20, is allocated to income (and paid to the

13 PEF Code §8141(c).
14 PEF Code §8146(b).
15 PEF Code §8143.
16 PEF Code §8146(a).
17 PEF Code § 8149.
18 PEF Code §8150.
19 PEF Code §§8145-8155.
20 PEF Code §8163.
21 PEF Code §8161.
22 PEF Code §8162.
23 PEF Code §8164.
24 PEF Code §8166(c).
25 PEF Code §8167.
26 PEF Code §8133.
Principal and Income Act, continued

next life tenant or the remainder beneficiary). The deceased life tenant receives nothing from the July 20 or August 20 rental payments.

If the life tenant has a power to withdraw more than 5% of the trust principal immediately prior to his death, the undistributed income is not paid to the beneficiary’s estate but is kept in principal. The reasoning is that by not withdrawing the principal, the beneficiary is content to have the income follow the principal.

Power to Adjust

If, after making all the allocations between income and principal called for by the detailed rules discussed above, the trustee is unable to administer the trust “impartially based on what is fair and reasonable to all of the beneficiaries, except to the extent that the governing instrument clearly manifests an intention that the trustee shall or may favor one or more of the beneficiaries,” the trustee then may, if the trustee chooses, exercise the power to adjust.

In order to exercise the power to adjust, the governing instrument must describe what the beneficiary receives by reference to the trust’s income. If a trust directs the payment of $1,000 a month to X, the power of adjustment is not given. On the other hand, if the trust instrument directs the trustee to sprinkle all the income among A and his children, the power to adjust is granted.

However, in certain situations the trustee cannot make an adjustment. A trustee who is a beneficiary may not exercise the power to adjust; but the other trustees may exercise such power. If having the power to adjust would cause a tax problem, the power is not given.

In deciding whether to exercise the power to adjust, a trustee may consider, among other things: the size of the trust; the nature and estimated duration of the trust; the liquidity and distribution requirements of the trust; the needs for regular distributions and preservation and appreciation of capital; the expected tax consequences of an adjustment; the net amount allocated to income under the other sections of the PEF Code, and the increase or decrease in the value of the principal assets; the particular assets held in the trust and the extent to which they consist of financial assets, closely owned businesses, tangible and intangible personal property or real property, and the extent to which an asset is used by a beneficiary, and whether an asset was purchased by the trustee or received from the testator; to the extent reasonably known to the trustee, the needs of the beneficiaries for present and future distributions; whether and to what extent the trust instrument authorizes the trustee to invade principal or accumulate income or prohibits invasions and accumulations, and the extent to which the trustee has exercised these powers from time to time; the intent of the testator; and the actual and anticipated effect of economic conditions on principal and income and effects of inflation and deflation.

These considerations are similar to those contained in the Prudent Investor Act. The appendix to this article contains a side-by-side comparison of the considerations in each statute. It would be useful for trustees to keep such a list handy.

Having considered all these things, the trustee must then decide what to do.

To exercise the power to adjust, the trustee simply does it. He simply calls income a certain amount of what otherwise would be principal, or calls principal a certain amount of what otherwise would be income.

The comments to the Uniform Act give an extensive description of various scenarios under which the exercise of the power of adjustment would be proper. They are appended at the end of this article.

Conversion to a Total Return Unitrust

The power to adjust has to be considered on each occasion it is exercised. As an alternative, the trustee can renounce the power to adjust and convert the trust into a total return unitrust. The total return unitrust then operates automatically.

In order to convert, the trustee must determine that the conversion to a unitrust will enable the trustee to better carry out the intent of the testator and the purposes of the trust. In addition, the trustee must give written notice of the

---

27 PEF Code §8133(a).
28 PEF Code §8104(a).
29 PEF Code §8104(a)(1).
30 PEF Code §8104(c)(7)(d).
31 PEF Code §8104(e).
32 PEF Code §8104(b).
33 PEF Code §8105(a).
34 PEF Code §8105(a)(1).

continued on page 8
**Principal and Income Act, continued**

must give written notice of the trustee’s intention to release the power to adjust and convert to a unitrust, and of how the unitrust will operate, to the *sui juris* beneficiaries who are currently eligible to receive income and who would (if no powers of appointment were exercised) be eligible to receive principal if the trust were to terminate immediately prior to the giving of the notice. There has to be at least one *sui juris* income beneficiary and at least one *sui juris* remainder beneficiary. If the trustee gives this notice and no such beneficiary objects within 60 days of the mailing of the notice, then the trustee may convert. If a beneficiary timely objects the trustee can convert only with court approval.

If there are no *sui juris* beneficiaries entitled to income, or no *sui juris* beneficiaries entitled to principal, the trustee needs court approval before converting. If the trustee decides not to convert, a trustee may request a trustee to convert, and if the trustee does not oblige, the beneficiary may ask the court to order the conversion.

In deciding whether to convert to a unitrust, the trustee may consider among other things the items mentioned previously that the trustee should consider in deciding whether to exercise the power of adjustment. See the appendix for a side by side list of these items.

If the trust is converted to a unitrust, the trustee must follow an investment policy seeking a total return from the trust investments, and the word income in the governing instrument is interpreted not to mean dividends and interest but instead to mean an annual distribution equal to 4% of the net fair market value of the trust’s assets. The value is determined by a three year average of the value of the trust’s assets.

Once converted to a unitrust, a trust can be deconverted only with court approval. With court approval a percentage pay-out different than 4% can be obtained, as well as certain other changes.

Trustees have to focus on how to communicate to their co-trustees and to their beneficiaries what it is they recommend, why they recommend it and the details of how they would operate a total return unitrust. The statute specifically gives trustees discretion to determine from time-to-time: the effective date of a conversion to a unitrust (presumably it would be some number of days after the 60 day notice period expires); the provisions for prorating unitrust distributions for the short year in which the beneficiary dies or for the first year; the frequency of distributions; the effect of payments from (or contributions to) the trust on the trust’s valuation (such as the payment of a large tax from the trust in the middle of the year); how frequently to value the trust’s assets (they must be valued at least annually, but in order to reduce volatility and to have substantial changes in market valuation more immediately affect the pay-out, some trustees may decide on quarterly valuations); what valuation dates to use; how frequently to value non-liquid assets; whether to omit from the calculations trust property occupied by a beneficiary such as a residence; and any other matters necessary for the proper functioning of the unitrust.

The 4% pay-out is net of expenses. In other words, all expenses (such as trustees’ fees) are paid from the funds that remain in the unitrust.

The unitrust distribution first pulls out income for tax purposes, then short term capital gains, then long term capital gains, and lastly principal. Accordingly, the beneficiary in a typical case would not pay income tax at ordinary rates on all that he receives.

Conversion to a unitrust essentially involves a re-definition of what is income. As a result, a provision authorizing invasion of principal is unaffected by a conversion to a unitrust.

**Protections for the Trustee**

Because of concern that these new discretionary powers are without substantial precedent, the Uniform Act provides protections

---

35 PEF Code §8105(a)(2).
36 PEF Code §8105(a)(3).
37 PEF Code §8105(a)(4).
38 PEF Code §8105(b)(1)(i).
39 PEF Code §8105(b)(1)(ii) and (iii).
40 PEF Code §8105(b)(2).
41 PEF Code §8105(c).
42 PEF Code §8105(d)(1).
43 PEF Code §8105(d)(3).
44 PEF Code §8105(d)(3).
45 PEF Code §8105(g)(4).
46 PEF Code §8105(g).

47. PEF Code §8105(e).
49. PEF Code §8105(f)(2).
50. PEF Code §8105(h).
### CONSIDERATIONS

<table>
<thead>
<tr>
<th></th>
<th>In Making Investment and Management Decisions&lt;sup&gt;1&lt;/sup&gt;</th>
<th>In Deciding Whether and to What Extent to Exercise the Power to Adjust&lt;sup&gt;2&lt;/sup&gt;</th>
<th>In Deciding Whether to Convert to Unitrust&lt;sup&gt;3&lt;/sup&gt;</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) the size of the trust</td>
<td>the size of the trust</td>
<td>the size of the trust</td>
<td></td>
</tr>
<tr>
<td>(2) the nature and estimated duration of the fiduciary relationship</td>
<td>the nature and estimated duration of the trust</td>
<td>the nature and estimated duration of the trust</td>
<td></td>
</tr>
<tr>
<td>(3) the liquidity and distribution requirements of the trust</td>
<td>the liquidity and distribution requirements of the trust</td>
<td>the liquidity and distribution requirements of the trust</td>
<td></td>
</tr>
<tr>
<td>(4)</td>
<td>the needs for regular distributions and preservation and appreciation of capital</td>
<td>the needs for regular distributions and preservation and appreciation of capital</td>
<td></td>
</tr>
<tr>
<td>(5) the expected tax consequences of investment decisions or strategies and of distributions of income and principal</td>
<td>the expected tax consequences of an adjustment</td>
<td>the expected tax consequences of the conversion</td>
<td></td>
</tr>
<tr>
<td>(6) the role that each investment or course of action plays in the overall investment strategy</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(7) an asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(8)</td>
<td>the net amount allocated to income under the other sections of the Principal and Income Act and the increase or decrease in the value of the principal assets, which the trustee may estimate as to assets for which market values are not readily available</td>
<td></td>
<td>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 or real property; the extent to which an asset is used by a beneficiary; and whether an asset was purchased by the trustee or received from the settlor or testator</td>
</tr>
<tr>
<td>(9)</td>
<td>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 or real property; the extent to which an asset is used by a beneficiary; and whether an asset was purchased by the trustee or received from the settlor or testator</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

---

1. See PEF Code §7203(c)

2. See §8104(b) of the PEF Code.

3. See §8105(c) of the PEF Code.
<table>
<thead>
<tr>
<th></th>
<th>to the extent reasonably known to the fiduciary, the needs of the beneficiaries for present and future distributions authorized or required by the governing instrument</th>
<th>to the extent reasonably known to the trustee, the needs of the beneficiaries for present and future distributions authorized or required by the governing instrument</th>
<th>to the extent reasonably known to the trustee, the needs of the beneficiaries for present and future distributions authorized or required by the governing instrument</th>
</tr>
</thead>
<tbody>
<tr>
<td>10</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>to the extent reasonably known to the fiduciary, the income and resources of the beneficiaries and related trusts</td>
<td>whether and to what extent the governing instrument gives the trustee the power to invoke principal or accumulate income or prohibits the trustee from invading principal or accumulating income, and the extent to which the trustee has exercised a power from time to time to invade principal or accumulate income</td>
<td>whether and to what extent the governing instrument gives the trustee the power to invoke principal or accumulate income or prohibits the trustee from invading principal or accumulating income, and the extent to which the trustee has exercised a power from time to time to invade principal or accumulate income</td>
</tr>
<tr>
<td>12</td>
<td>the intent of the settlor or testator</td>
<td>the actual and anticipated effect of economic conditions on principal and income and effects of inflation and deflation</td>
<td>the actual and anticipated effect of economic conditions on principal and income and effects of inflation and deflation</td>
</tr>
<tr>
<td>13</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>14</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Appendix**

**Uniform Principal and Income Act**

**Comments Illustrating the Use of the Power to Adjust**

**Examples.** The following examples illustrate the application of section 8104:

*Example (1)* -- T is the successor trustee of a trust that provides income to A for life, remainder to B. T has received from the prior trustee a portfolio of financial assets invested 20% in stocks and 80% in bonds. Following the prudent investor rule, T determines that a strategy of investing the portfolio 50% in stocks and 50% in bonds has risk and return objectives that are reasonably suited to the trust, but T also determines that adopting this approach will cause the trust to receive a smaller amount of dividend and interest income. After considering the factors in section 8104(b), T may transfer cash from principal to income to the extent T considers it necessary to increase the amount distributed to the income beneficiary.

*Example (2)* -- T is the trustee of a trust that requires the income to be paid to the settlor’s son C for life, remainder to C’s daughter D. In a period of very high inflation, T purchases bonds that pay double-digit interest and determines that a portion of the interest, which is allocated to income under section 8146 of this Act, is a return of capital. In consideration of the loss of value of principal due to inflation and other factors that T considers relevant, T may transfer part of the interest to principal.

*Example (3)* -- T is the trustee of a trust that requires the income to be paid to the settlor’s sister E for life, remainder to charity F. E is a retired schoolteacher who is single and has no children. E’s income from her social security, pension, and savings exceeds the amount required to provide for her accustomed standard of living. The terms of the trust permit T to invade principal to provide for E’s health and to support her in her accustomed manner of living, but do not otherwise indicate that T should favor E or F. Applying the prudent investor rule, T determines that the trust assets should be invested entirely in growth stocks that produce...
very little dividend income. Even though it is not necessary to invade principal to maintain E’s accustomed standard of living, she is entitled to receive from the trust the degree of beneficial enjoyment normally accorded a person who is the sole income beneficiary of a trust, and T may transfer cash from principal to income to provide her with that degree of enjoyment.

Example (4) -- T is the trustee of a trust that is governed by the law of State X. The trust became irrevocable before State X adopted the prudent investor rule. The terms of the trust require all of the income to be paid to G for life, remainder to H, and also give T the power to invade principal for the benefit of G for “dire emergencies only.” The terms of the trust limit the aggregate amount that T can distribute to G from principal during G’s life to 6% of the trust’s value at its inception. The trust’s portfolio is invested initially 50% in stocks and 50% in bonds, but after State X adopts the prudent investor rule T determines that, to achieve suitable risk and return objectives for the trust, the assets should be invested 90% in stocks and 10% in bonds. This change increases the total return from the portfolio and decreases the dividend and interest income. Thereafter, even though G does not experience a dire emergency, T may exercise the power to adjust under section 8104(a) to the extent that T determines that the adjustment is from only the capital appreciation resulting from the change in the portfolio’s asset allocation. If T is unable to determine the extent to which capital appreciation resulted from the change in asset allocation or is unable to maintain adequate records to determine the extent to which principal distributions to G for dire emergencies do not exceed the 6% limitation, T may not exercise the power to adjust. See Joel C. Dobris, Limits on the Doctrine of Equitable Adjustment in Sophisticated Postmortem Tax Planning, 66 Iowa L. Rev. 273 (1981).

Example (5) -- T is the trustee of a trust for the settlor’s child. The trust owns a diversified portfolio of marketable financial assets with a value of $600,000, and is also the sole beneficiary of the settlor’s IRA, which holds a diversified portfolio of marketable financial assets with a value of $900,000. The trust receives a distribution from the IRA that is the minimum amount required to be distributed under the Internal Revenue Code, and T allocates 10% of the distribution to income under section 8149(d) of this Act. [N.B. Pennsylvania has changed the Uniform Act on this point.] The total return on the IRA’s assets exceeds the amount distributed to the trust, and the value of the IRA at the end of the year is more than its value at the beginning of the year. Relevant factors that T may consider in determining whether to exercise the power to adjust and the extent to which an adjustment should be made to comply with section 8103(b) include the total return from all of the trust’s assets, those owned directly as well as its interest in the IRA, the extent to which the trust will be subject to income tax on the portion of the IRA distribution that is allocated to principal, and the extent to which the income beneficiary will be subject to income tax on the amount that T distributes to the income beneficiary.

Example (6) -- T is the trustee of a trust whose portfolio includes a large parcel of undeveloped real estate. T pays real property taxes on the undeveloped parcel from income each year pursuant to section 8161. After considering the return from the trust’s portfolio as a whole and other relevant factors described in section 8104(b), T may exercise the power to adjust under section 8104(a) to transfer cash from principal to income in order to distribute to the income beneficiary an amount that T considers necessary to comply with section 8103(b).

Example (7) -- T is the trustee of a trust whose portfolio includes an interest in a mutual fund that is sponsored by T. As the manager of the mutual fund, T charges the fund a management fee that reduces the amount available to distribute to the trust by $2,000. If the fee had been paid directly by the trust, one-half of the fee would have been paid from income under section 8161 and the other one-half would have been paid from principal under section 8162. [N.B. Pennsylvania has changed the Uniform Act on this point.] After considering the total return from the portfolio as a whole and other relevant factors described in section 8104(b), T may exercise its power to adjust under section 8104(a) by transferring $1,000, or half of the trust’s proportionate share of the fee, from principal to income.

NOTE: The statutory references in these comments have been changed from the Uniform Act’s sections to Pennsylvania’s PEF Code sections.
Principal and Income Act, continued

for the trustee. Pennsylvania generally follows these provisions.

Pennsylvania reminds the court not to change a trustee’s decision to exercise or not to exercise discretion with respect to principal and income matters unless it determines that the decision was an abuse of the trustee’s discretion. This means that the court must not simply think the trustee was wrong, but must think the decision lay outside the bounds of reasonableness. This is a restatement of present law.

The more important provision is that if the court determines that the trustee did abuse its discretion, the remedy is to restore the income and remainder beneficiaries to the positions they would have occupied if the trustee had not abused its discretion. The court might order the trustee to make an additional distribution to the life tenant or to withhold distributions from the life tenant to reimburse the trust principal. If the abuse of discretion concerns the power to convert to a unitrust, the remedy is to require the trustee to convert to a unitrust or to reconvert from a unitrust. The court may require the trustee to pay damages only if the court is unable by these techniques to restore the beneficiaries to the positions they would have occupied if the trustee had not abused its discretion.

The Pennsylvania Principal and Income Act: Comparisons with Similar State Laws and Aspects of Trustee Responsibility

By CHARLES M. AULINO
THE GLENMEDE TRUST COMPANY

A look at the approaches taken by some of the other states that have enacted variations of the Uniform Principal and Income Act and separate unitrust conversion statutes can help to put the new Pennsylvania law into perspective. This article will provide some of those comparisons and then go on to examine how trustees may react, not only based on the new law but also in view of developments in the financial markets. The comparisons with other state laws only concern unitrust conversion, but the impact of investment trends affects a trustee’s use of the power to adjust as well as unitrust conversion.

Comparison #1: What trusts may be converted?

With only a few logical exceptions, Pennsylvania law permits conversion of most existing trusts. At least two other states have significant limitations on the conversion power. An existing trust in Missouri may be converted to a unitrust only if conversion occurs within two years after the effective date of the statute, August 28, 2001. Furthermore, trusts created after that date may be converted only if the document “clearly manifests an intent that (the new law) apply.” It seems that, in Missouri, you have to show me” that you meant to allow for conversion! Similarly, New York permits conversion of existing trusts until December 31, 2005 but also allows newer trusts to be converted on or before the end of the second full year after funding.

Restrictions such as those found in Missouri and New York make it necessary for the trustee to make a decision within a confined period of time and seem to allow no flexibility in case of changed circumstances. In contrast, the Pennsylvania rule gives the trustee the luxury of time to make a decision on conversion. If circumstances do not warrant the change presently, the trustee is free to consider it at any time in the future.

Comparison #2: Who participates in the decision?

All of the states that have enacted unitrust conversion rules give the trustee either exclusive or primary prerogative concerning conversion to a unitrust. There are interesting nuances, however, regarding what role, if any, is given to beneficiaries. The Pennsylvania rule covers all of the bases. It specifically mentions a beneficiary’s right to request that the trustee make the conversion and, if

51 PEF Code §8106(a).
52 PEF Code §8106(b).

1 PEF Code §8105(h)(1).
2 Missouri Statutes §469.411.5.

continued on page 10
Principal and Income Act: Comparisons, continued

the trustee declines, to seek a conversion order from the court. New York takes a slight step further by giving any beneficiary the direct right to apply for an order converting to a unitrust rather than first requesting the trustee to do so. In Delaware and Missouri, there is no specific authority for the beneficiary to take action if the trustee declines.

Comparison #3: What is the unitrust percentage?

In this regard, the Delaware law appears to provide the greatest flexibility. There is a range of unitrust percentages with a minimum of 3% and a maximum of 5% and the trustee is permitted to make periodic changes in the unitrust percentage. Pennsylvania’s default is 4%, but the trustee can seek court permission to use a different percentage. Missouri has a 3% minimum and no maximum unitrust percentage but most of the other states are far less flexible with New York, for example, simply providing for a 4% unitrust pay-out.

Comparison #4: Do beneficiaries receive notice?

It is common to find children of the settlor (or testator of a testamentary trust) as the current income beneficiaries and grandchildren as the remainders. Assuming that notice of a proposed unitrust conversion must be sent to current and future beneficiaries, if the typical rule of virtual representation were to apply, it might be possible to notify the children of the settlor on behalf of themselves as well as the grandchildren. Considering the magnitude of the potential conflict of interest, however, that seems a curious result. Nevertheless, the New York law simply requires that notice be sent to all parties to whom service of process would be required for judicial settlement of the trustee’s account.

In contrast, Delaware and Pennsylvania both require that there be at least one current and one future beneficiary who are sui juris as a pre-requisite to unitrust conversion without court approval.

New Jersey law does not provide for unitrust conversion but there is a safe harbor in the power to adjust enabling the trustee to increase income up to 4% or decrease it to 6% with a presumption of reasonableness. There are no provisions for notice whatsoever.

Comparison #5: How are different categories of income allocated to the unitrust amount?

In the current environment of the financial markets, the unitrust amount is likely to exceed the ordinary investment income produced by any trust fund that holds financial investments. Of all the states that have enacted unitrust conversion laws, Pennsylvania’s contains the most specific guidance on how to report to the beneficiary that portion of the unitrust amount that exceeds accounting net income (“ANI”). It requires that the excess be treated first as short-term capital gain, next as long-term capital gain and finally, tax-free distribution of principal. The Missouri and New York laws are silent on the topic and Delaware leaves the subject to the discretion of the trustee.

It is worth noting that proposed federal income tax regulations published on February 15, 2001 address the subject of how IRC §§643(b) and 643(a)(3) are “intertwined” with new state law provisions governing the definition of income. The issue is whether or not realized capital gains are required to be included in distributable net income (“DNI”), and thus taxable to the beneficiary rather than to the trust, when the unitrust amount exceeds accounting net income (“ANI”). The preamble to the regulations does not state that including capital gains in DNI is required under those circumstances. Instead, it requires that result only if state law mandates such allocation (that would be the result in Pennsylvania).

Examples 9 and 10 of the proposed federal regulations appear as if they were written to describe the results in Pennsylvania and Delaware, respectively, although these regulations were published before the laws of either state were enacted. Example 9 states that

---

4 PEF Code §8105(b)(2).
6 §§3527(f) and (b) of Title 12 of the Delaware Code.
7 PEF Code §8105(d)(3).
8 PEF Code §8105(g)(1).
9 Missouri Statutes §469.411.5.(2).
10 N.Y.E.P.T.L. §11-2.4(B).
11 N.Y.E.P.T.L. §11-2.4(E)(2) and (E)(4)(B).
12 PEF Code §8105(a)(3), §3527(b)(3) of Title 12 of the Delaware Code.
13 N.J.S.A. 3B:19B-4a.
14 PEF Code §8105(f)(2).
15 §3527(h)(2) of Title 12 of the Delaware Code.
17 Prop. Regs. §1.643(a)-3(e).

continued on page 11
The existence of these studies, and the analytic techniques they describe, place an additional duty on the trustee to show that probability of preserving future purchasing power of principal has been considered. Upon account settlement for a converted unitrust where the principal value has not performed well, lack of any record of such analysis could prove embarrassing or worse for the trustee.

Following is an example of an approach that documents a trustee’s consideration of the probable future effects of conversion on the ability of the trust fund to maintain purchasing power. It begins with a listing of expected long-term rates of return and standard deviation assumptions for different asset classes, followed by a graph that shows the range of probable outcomes for a trust that uses a 4% unitrust pay-out with inflation at 3% per year. In this case the probable outcomes are compared for a traditional 60% - 40% asset allocation on the left side and for a more broadly diversified portfolio of asset classes on the right.

Notice that, for the traditional 60/40 mix, the average (50-50 probability) outcome is slightly ahead of inflation while the broadly diversified portfolio foretells a somewhat improved average result. The illustration also serves the purpose of documenting that the trustee has considered the range of possible outcomes and, presumably, shared this range of possibilities with the current and future beneficiaries.

**Conclusion**

Pennsylvania has a modern principal and income act that provides the trustee with great flexibility in dealing with the often-conflicting interests of present and future beneficiaries in a manner that offers a fair and reasonable approach to all. At the same time, this law places a greater burden of responsibility than ever on trustees to analyze each individual situation and to estimate the range of future possible outcomes.

---

**NEWSLETTER ARTICLES**

What would you like to see in future issues of the Probate & Trust Law Section Newsletter? The Publications Committee is looking for articles and ideas of interest to the probate bar. Please send any articles or ideas to:

Susan G. Collings, Esquire
Drinker Biddle & Reath LLP
One Logan Square
18th & Cherry Streets
Philadelphia, PA 19103-6996
(215) 988-2618
<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Expected Return</th>
<th>Standard Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inflation</td>
<td>3.0%</td>
<td>3.2%</td>
</tr>
<tr>
<td>Cash Reserves (Tax-Free)</td>
<td>3.0%</td>
<td>2.6%</td>
</tr>
<tr>
<td>Governments</td>
<td>5.0%</td>
<td>5.5%</td>
</tr>
<tr>
<td>TIPS</td>
<td>6.0%</td>
<td>3.5%</td>
</tr>
<tr>
<td>Municipals</td>
<td>4.3%</td>
<td>4.3%</td>
</tr>
<tr>
<td>Taxable Bonds</td>
<td>6.0%</td>
<td>5.7%</td>
</tr>
<tr>
<td>High Yield</td>
<td>8.0%</td>
<td>12.6%</td>
</tr>
<tr>
<td>Non-US Bonds</td>
<td>7.0%</td>
<td>9.2%</td>
</tr>
<tr>
<td>Domestic Large Cap Equity</td>
<td>9.0%</td>
<td>16.7%</td>
</tr>
<tr>
<td>Domestic Small Cap Equity</td>
<td>10.0%</td>
<td>19.2%</td>
</tr>
<tr>
<td>International Equity</td>
<td>9.0%</td>
<td>22.4%</td>
</tr>
<tr>
<td>Emerging Markets</td>
<td>10.0%</td>
<td>31.8%</td>
</tr>
<tr>
<td>Hedge Funds</td>
<td>10.0%</td>
<td>6.0%</td>
</tr>
<tr>
<td>Private Equity</td>
<td>14.0%</td>
<td>21.2%</td>
</tr>
<tr>
<td>Real Estate</td>
<td>9.0%</td>
<td>8.1%</td>
</tr>
</tbody>
</table>

Note: Standard deviations and downside risk probabilities are based on expected return assumptions and volatilities of historical index returns (1970 – 2001). Information is based on sources that we believe to be reliable but Glenmede does not guarantee its completeness or accuracy. Future results cannot be guaranteed.
Traditional and Diversified Asset Mixes

Initial Portfolio Value = $10 Million

Note: The left-hand axis for each graph shows portfolio value in $ millions.

Note: Standard deviations and downside risk probabilities are based on expected return assumptions and volatilities of historical index returns (1970 – 2001). Information is based on sources that we believe to be reliable but Glenmede does not guarantee its completeness or accuracy. Future results cannot be guaranteed.
Proposed regulations under Section 401(a)(9) of the Internal Revenue Code of 1986 ("Code") were originally issued in 1987, to provide rules for minimum distributions from qualified retirement plans, individual retirement accounts and annuities, Section 403(b) tax-sheltered annuities, and certain 457 deferred compensation plans. The proposed regulations were amended briefly in 1997 and extensively in 2001, and were further amended and made final in April of 2002. These very complex regulations have been analyzed in detail, in articles published locally, in national publications, and on numerous web sites. Many of these sources repay careful study, and demonstrate that even the final regulations leave many questions unanswered. Private letter rulings regularly highlight, without always answering, some of these questions. In addition, as of this writing, Congress is considering legislation to change the minimum distribution rules again. It is safe to assume that minimum distribution issues will continue to arise in coming years, as more people with substantial retirement accounts reach age 70. While any summary of the recent regulation changes risks being misleading through lack of comprehensiveness, there are a few principal changes in the (so far) final regulations that can be highlighted.

1. Changes in life expectancy tables. The final regulations include a new Uniform Lifetime Table, which is used for determining minimum required lifetime distributions, as well as the other life expectancy table. The new tables reflect increasing life expectancies. Consequently, distributions may not be stretched out over a longer period. The leading book on the subject of required minimum distributions and related topics, Natalie Chote’s Life and Death Planning for Retirement Benefits contains, in its recent 2002 edition, the prior Uniform Lifetime Table. The supplement to the 2002 edition, 43 pages in length, can be found on her web site, www.ataxplan.com.

2. Changes in separate account rules. When more than one person is named as beneficiary for a retirement account, the ability of each beneficiary to use his own life expectancy in determining minimum distribution depends on whether separate accounts have been set up soon enough. The final regulations add more certainty to the process of establishing separate accounts. The separate accounts for beneficiaries of a deceased account owner must be established by December 31 of the year following the year of the owner’s death. The beneficiaries must have interests that are recognized as separate as of the date of the account owner’s death. Until the actual separate accounts are set up, gains and losses must be allocated proportionately.

3. Change in the beneficiary disclosure date. The final regulations set September 30 of the year following the year of death as the date for determining who are the beneficiaries of a retirement account. This permits changes in the beneficiaries of the account through disclaimers or distributions of benefits. It does not permit the addition of new beneficiaries not named by the account owner. This technique can be effective in avoiding the shorter distribution period that occurs when one of the beneficiaries of a retirement account is a charity. The charity can be paid out before the September 30 deadline, and the remaining beneficiaries can benefit from a longer distribution period.

4. Clarification of several rules. The final regulations make clear some points that were previously at issue.

- It now seems clear that an estate that is a beneficiary of a decedent’s account cannot, by distributing the right to receive the account to beneficiaries of the estate, create separate accounts for beneficiaries for which they can use their own life expectancies to measure required minimum distributions.

- The death of a designated beneficiary prior to September 30 of the year following the year of the account owner’s death does not prevent the use of that beneficiary’s life expectancy for determining required minimums.

- Marital status is determined as of January 1 of a year, in calculating required minimum distributions, even if death or divorce occurs during the year.

continued on page 15
Section 529 Plans and Uniform Transfers to Minors Accounts

By AMY NEWNAM, ESQ., SCHNADER, HARRIS, SEGAL & LEWIS LLP
KAREN STOCKMAL, ESQ., PEPPER HAMILTON, LLP

Scenario: For a number of years, your client has carefully transferred assets into the names of her minor children using Uniform Transfers to Minors Act ("UTMA") Accounts for which she is the custodian. Her intention is that someday, these funds will be used to pay for each child's education. She now wants to know if she can, and should, transfer the assets into Section 529 Plans for each child.

UTMA Accounts vs. Section 529 Plans - The Basics

To answer your client's question, it is necessary to first understand the advantages and disadvantages of each technique. The concept behind UTMA in Pennsylvania1, and in other states that have enacted either UTMA or the Uniform Gifts to Minors Act, is that minors are not legally capable of holding title to property. Therefore, the law creates a mechanism to permit a custodian to hold and manage a minor's property for the benefit of the minor until the minor reaches the age of majority. The basic concept behind Section 529 Plans2 is to provide tax incentives for taxpayers who save for their children's and grandchildren's college educations.

There are similarities and differences between these two techniques when implemented as a way of saving for college. In order to advise clients appropriately, it is necessary for the client to identify his or her goals and intentions. One of the benefits of an UTMA account is that it provides a simple method by which a donor can take advantage of the annual gift tax exemption amount.

1 20 Pa. C.S. Ch. 53.

2 Section 529 of the Internal Revenue Code of 1986, as amended.

Final Minimum Distribution Regulations, continued

Administrators and custodians of retirement accounts must, beginning in 2003, calculate the account owner's minimum distribution, or offer to do so.

If an account owner dies after the required beginning date for distributions, the beneficiary may continue to use the decedent's life expectancy, which is helpful if the beneficiary is older.

The final regulations are effective for distributions on or after January 1, 2003. For 2002, the 1987, 2001 or 2002 versions of the regulations may be used. We can expect to see more developments in this area of the law, particularly regarding the use of trusts as beneficiaries and the question of when contingent beneficiaries must be considered in calculating required minimums. Adoption of any of the proposals for changing the statutory rules will also require further amendment of the regulations.

while transferring money to the next generation. Thus, a donor may currently contribute $11,000 per year, per donee to an UTMA account without incurring a gift tax.

Similarly, Section 529 Plans offer donors an opportunity to utilize their annual gift tax exemption amounts, and in fact go one step farther by offering donors an opportunity to “front-load” their gifts.

A donor to a Section 529 Plan can invest up to $55,000 in the first year ($110,000 for a married couple) per donee and pro rate that amount over five years to avoid applying the gift tax exemption or incurring gift tax, assuming that no other gifts are made during the five-year period.

A second benefit of UTMA accounts is that the donor can contribute any type of property — real or personal, tangible or intangible — to the account. The custodian of the account can also convert the assets at any time. In contrast, contributions to a Section 529 Plan must be in cash, and the investments are restricted to those offered by the individual plan. Furthermore, transfers among Section 529 Plan investments cannot be made more frequently than once per calendar year or each time the beneficiary designation is changed.

Because investment choices for an UTMA account are not limited to those offered by any particular plan, UTMA accounts ultimately provide more investment flexibility than Section 529 Plans.

continued on page 16
Section 529 Plans, continued

A third benefit of UTMA accounts is that the assets can be used for any purpose, not just education, and there is no penalty for doing so. In contrast, Section 529 Plans are intended to be used for education expenses and, as discussed below, there is a penalty when the funds are withdrawn other than to pay for qualified educational expenses. A client who is choosing between an UTMA account and a Section 529 Plan will want to consider whether use of the funds for educational expenses is a primary goal of establishing the account.

The three benefits of UTMA accounts are, for many clients, outweighed by several disadvantages. First, ownership (and therefore control) of the account must transfer to the minor upon his or her reaching the age of majority. UTMA requires that the assets vest indefeasibly in the minor upon reaching the age of majority. Accordingly, the beneficiary of the UTMA account can use the assets for any desired purpose, whether related to education or not, once he or she is an adult.

In contrast, a Section 529 Plan allows the contributor to retain a degree of control over the assets even after the beneficiary reaches the age of majority. The account owner authorizes all distributions and can even withdraw money from the account for purposes other than qualified educational expenses if he or she is willing to incur tax and a penalty on the earnings. In addition, if the beneficiary does not go to college, the Section 529 Plan can be transferred by the account owner to a sibling or other qualified beneficiary (a “member of the family”) without incurring any negative tax consequences.

Moving assets from UTMA to 529 - The Logistics

Based on the advantages and disadvantages discussed above, many clients who have existing UTMA accounts are now asking whether a Section 529 Plan might better meet their goals. The question these clients are asking is whether they can transfer the assets currently held in the UTMA accounts to Section 529 Plans. With caveats, they often can.

A client who is interested in transferring assets from an UTMA account to a Section 529 Plan must first find a Section 529 Plan that will accept such a transfer. Most, but not all plans, do. Then, because federal law requires that contributions to Section 529 Plans be in cash, non-cash assets in the UTMA account must be liquidated prior to the transfer. Liquidation of the assets involves paying the applicable taxes, including capital gains tax.

Next, the custodian of an UTMA account may transfer the assets into a Section 529 Plan account for the designated beneficiary. The custodian becomes the account owner. However, in most places the custodian does not have the same privileges under state law to rollover UTMA funds to another beneficiary that a contributor to a Section 529 Plan generally would. As previously discussed, the custodian of an UTMA account is obligated under fiduciary law in Pennsylvania (and in many other states) to maintain the account for the benefit of the minor child only. Because a transfer to an UTMA account is irrevocable, conveying to the minor indefeasibly vested legal title to the property, the property held in the custodial account would not be eligible for transfer.

In a Section 529 Plan, all investment earnings for federal income tax purposes are tax-deferred until withdrawn and are tax-exempt if used to pay for qualified education expenses. For non-qualified withdrawals, the earnings are included in the distributee’s gross income in the year of the withdrawal and there is a 10% penalty on the earnings. In addition, capital gain is converted into ordinary income on all distributions.

State income tax treatment varies from state to state and from plan to plan. Therefore, the tax treatment of transferring assets from an UTMA account to a Section 529 Plan is not uniform. For example, in some states, the transfer is subject to state income tax, even if the funds were earned in a UTMA account that is not subject to state income tax. In other states, the transfer is tax-free. Therefore, it is important to consult with a tax professional to determine the specific tax implications of transferring assets from an UTMA account to a Section 529 Plan.

A client who is interested in transferring assets from an UTMA account to a Section 529 Plan must first find a Section 529 Plan that will accept such a transfer. Most, but not all plans, do. Then, because federal law requires that contributions to Section 529 Plans be in cash, non-cash assets in the UTMA account must be liquidated prior to the transfer. Liquidation of the assets involves paying the applicable taxes, including capital gains tax.

In a Section 529 Plan, all investment earnings for federal income tax purposes are tax-deferred until withdrawn and are tax-exempt if used to pay for qualified education expenses. For non-qualified withdrawals, the earnings are included in the distributee’s gross income in the year of the withdrawal and there is a 10% penalty on the earnings. In addition, capital gain is converted into ordinary income on all distributions.

1 State income tax treatment varies from state to state and from plan to plan. Therefore, the tax treatment of transferring assets from an UTMA account to a Section 529 Plan is not uniform. For example, in some states, the transfer is subject to state income tax, even if the funds were earned in a UTMA account that is not subject to state income tax. In other states, the transfer is tax-free. Therefore, it is important to consult with a tax professional to determine the specific tax implications of transferring assets from an UTMA account to a Section 529 Plan.

In a Section 529 Plan, all investment earnings for federal income tax purposes are tax-deferred until withdrawn and are tax-exempt if used to pay for qualified education expenses. For non-qualified withdrawals, the earnings are included in the distributee’s gross income in the year of the withdrawal and there is a 10% penalty on the earnings. In addition, capital gain is converted into ordinary income on all distributions.

1 State income tax treatment varies from state to state and from plan to plan. Therefore, the tax treatment of transferring assets from an UTMA account to a Section 529 Plan is not uniform. For example, in some states, the transfer is subject to state income tax, even if the funds were earned in a UTMA account that is not subject to state income tax. In other states, the transfer is tax-free. Therefore, it is important to consult with a tax professional to determine the specific tax implications of transferring assets from an UTMA account to a Section 529 Plan.
Ethics Column

BY PAUL C. HEINTZ
OBERMAYER, REBMANN, MAXWELL & HIPPEL, LLP

Question: May a lawyer undertake the defense of a trustee in its individual or corporate capacity in a surcharge action brought by the beneficiaries while also representing the trustee in its fiduciary capacity during a routine trust administration?

No Pennsylvania judges, ethic opinion writers or Pennsylvania commentators have taken the position that counsel for the fiduciary is automatically disqualified from assuming the traditional counsel role for the fiduciary, in its individual or corporate capacity, when a beneficiary threatens actions or actually lodges claims against the fiduciary. In fact, there is support for accepting the dual role. See Volume 28, Real Property Probate, Trust Journal No. 4 (Winter, 1994), Counseling the Fiduciary at page 855.

However, whether a lawyer may represent a trustee in both its fiduciary and individual or corporate capacities simultaneously depends largely upon the nature of the surcharge action and the involvement of the lawyer in the acts that prompted the surcharge action.

Lawyers should be mindful of three principles when contemplating the dual roles: First, it is probably the law now in Pennsylvania that counsel to trustees owe certain derivative duties to the beneficiaries. The principle was first formally enunciated by Judges Taxis and Ott in Pew Trusts, 16 Fiduc. Rep. 2d 73 and 80 (Montg. 1995). Those derivative duties include the obligation of notifying the beneficiaries of the misbehavior of a fiduciary notwithstanding the obligations we lawyers have to maintain confidentiality pursuant to Rule 1.6 of the Rules of Professional Conduct. Second, a lawyer may be disqualified when implicated in the trustees action if the lawyer provided opinions that approved or endorsed the action in question or failed to mitigate or prevent harm caused by the actions. Third, a trustee cannot withhold from the beneficiaries any documents regarding the management of the trust, including the routine legal opinions rendered the trustee to guide the trustee in the administration of the trust. See Follansbee v. Gerlach and Reed Smith, 22 Fiduc. Rep. 2d 319 (Civ. Div. Allegh. 2002), annotated Fiduc. Rev. Oct. 2002, p. 3.

Accordingly, if we wish to undertake the defense of the fiduciary in an action brought by the beneficiaries, we must first ask if fulfilling our derivative duties, such as providing mandatory notice to the beneficiaries of a trustees improper actions, would in any way compromise our ability to effectively represent the fiduciary. In the cases of an egregious breach of fiduciary duty, such as theft, it would seem unlikely the lawyer should undertake the defense, particularly if the lawyers services were used in the course of such breach. Second, we should ask ourselves if the action about which the beneficiary complains is one that we were aware of and even may have endorsed by way of an opinion letter. If the lawyers involvement is such that he or she would be called as a witness by either side, that lawyer may not be able to undertake the representation. If not precluded from

Section 529 Plans, continued

account is owned by the minor child. Thus, if UTMA assets are transferred to a Section 529 Plan, the minor technically owns the Section 529 Plan account.

To handle these situations, most Section 529 Plans require that the minor become the account owner upon reaching the age of majority. In addition, most Section 529 Plans limit the power of a former UTMA account custodian to perform rollovers or to make nonqualified withdrawals on behalf of individuals other than the minor. If the custodian does rollover the Section 529 Plan to a new beneficiary, he or she may be liable to the original beneficiary under fiduciary state law.

As is most often the case, there is no one "right" answer for the client who asks whether he or she should transfer existing UTMA accounts to Section 529 Plans. While there is no prohibition to such a transfer under federal law, the advisability of doing so will depend on the client's intentions for the future use of the assets and on the relative desire to reduce income taxes.

Probate and Trust Law Section Newsletter No. 105

continued on page 18
Ethics Column, continued

serving as counsel for either of these reasons, it is likely the lawyer may undertake the defense of the fiduciary.

There is a remaining challenge, however: Preserving the protections afforded the trustee by the attorney-client privilege. Notwithstanding the general rule that beneficiaries have the right to obtain copies of opinions rendered by counsel to the trustee, support for the opinion that some communications between the fiduciary and its counsel may be deemed privileged, can be found in the Restatement (Second) Trusts, § 173. Comment (b) to § 173 provides: The trustee is privileged to refrain from communicating to the beneficiary information acquired by the trustee at his own expense and for his own protection. Thus, he is privileged to refrain from communicating to the beneficiary opinions of counsel obtained by him at his own expense and for his own protection. It is important to remember, however, that in order for the trustee to be able to assert the attorney-client privilege, the documents must have been generated in anticipation or the defense of litigation and they should be appropriately marked.

Protecting the important attorney-client privilege for the benefit of the client in its individual or corporate capacity generally requires three safeguards. First, both the lawyer and the trustee should maintain files separate from the administration files for the retention of all documents related to the litigation, either anticipated or initiated, that the parties deem privileged communications. Second, all privileged communications should be so marked. Finally, any fees paid to the lawyer for the separate representation should be paid by the trustee, at least initially, from its individual or corporate funds. Of course, if the trustee prevails in the surcharge action, the trustee may, under Pennsylvania law, seek reimbursement of its legal fees from the trust.

In typical surcharge actions, many of which involve allegations of excessive compensation or poor investment performance, the lawyer usually may represent the trustee in both capacities simultaneously.

WHAT WOULD YOU LIKE TO SEE IN FUTURE ETHICS COLUMNS?

Send your questions and ideas to:

Paul C. Heintz, Esquire
Obermayer, Rebmann, Maxwell & Hippel, LLP
1617 JFK Boulevard
One Penn Center
19th Floor
Philadelphia, PA
19103

JOIN A COMMITTEE

The Section’s Committees depend on the steady flow of people, energy and ideas. Join one! Fill in the form below and send it to the Section Chair:

Norman E. Donoghue, II
Dechert
4000 Bell Atlantic Tower
1717 Arch Street
Philadelphia, PA 19103
(215) 994-2539

Name: ________________________________
Address: _______________________________

Committee Preferences:
First: ________________________________
Second: ______________________________
Third: ________________________________
Tax Update

By JOAN AGRAN
PEPPER HAMILTON, LLP

I. COURT DECISIONS

Adjustments for Inflation Do Not Qualify for QTIP

In Estate of Sansone v. U.S., (CA9 6/11/2002) 90 AFTR 2d 2002-3065, decedent created a trust that, on his death, provided a $100,000 annuity for his wife's life and included annual adjustments for inflation. On the termination of the trust, the residue would be distributed to charity. The estate made a QTIP election for the trust on the estate tax return, initially claiming a marital deduction for the amount necessary to produce the $100,000 annuity. The estate later filed a refund and claimed that an additional part of the trust corpus qualified for the marital deduction, arguing that the valuation formula in the QTIP regulations unfairly barred the estate from taking into account increases in the annual annuity payments for Decedent's wife. The IRS denied the estate's refund claim.

A U.S. district court held that the annual payments qualified for the QTIP marital deduction, but that the estate wasn't entitled to an increased marital deduction based on the possible increase in payments to the surviving spouse.

The Court of Appeals for the Ninth Circuit, in upholding the District Court, found that while QTIP annual payments may be adjusted for inflation, the potential increase isn't considered in valuing the deductible interest under section 2056. The court also held that the trust did not qualify as a charitable remainder trust under section 664 due to the fluctuations in the payout to decedent's widow.

Deductions for Executor's Fees Limited to Probate Estate

In Estate of Grant, (CA2 6/21/2002) 89 AFTR 2d 2002-3063, the Second Circuit held that an estate is entitled to deduct executor's fees based only on the size of the probate estate and not the size of the combined trust-probate estate.

In 1991, Decedent transferred most of her property to a trust for her two children. She died three years later, leaving her children as her heirs and the estate's executors. The estate filed a federal estate tax return reporting trust assets of $865,480 and nontrust assets of $11,253. The estate claimed $48,102 in administration expenses, including $16,875 in personal representatives' fees. The IRS disallowed the deductions and various other expenses. The estate petitioned the Tax Court and argued that the maximum allowable compensation under state law was $32,200 for estates valued at more than $850,000. The estate insisted that because it was claiming less than $32,200 for fees, the full amount claimed was allowable.

The Tax Court disagreed, holding that, based on the size of the estate subject to administration, the maximum fees allowable under state law were $1,000. The court rejected the argument that because the fees were allowable under local law, they were allowable under federal law.

The Court of Appeals concluded that the allowability of an expense under local law is a threshold requirement that must be satisfied before considering section 2053 requirements. The court held that for an expense to be deductible under section 2053, it must qualify as an administration expense under both state and federal law. Agreeing with the Tax Court, the Court concluded that the executors spent most of their time handling the trust assets and not the probate property, which was not "necessary" for the administration of the estate under section 2053, and limited the deduction of the executors' fees according to the value of the estate assets.

Disclaimer of Remainder Interest Not Qualified

In Walshire v. U.S., (CA8 5/01/2002) 89 AFTR 2d 2002-2215, the Court of Appeals for the Eighth Circuit held that the district court properly held that a decedent's disclaimer of his remainder interest in his predeceased brother's estate, while retaining a life interest was not a qualified disclaimer under Code Sec. 2518(a). The court upheld the validity of Regulation §25.2518-3(b), which specifically excludes horizontal property divisions, finding that the regulation was consistent with and represented a valid
The Court affirmed the Tax Court’s holdings that the FLP had a business purpose and economic substance and shouldn’t be disregarded for estate tax purposes; and that section 2703 didn’t apply to the agreement and that the transfer to the partnership wasn’t a gift.

However, in regard to the 2036 claim, the Appeals Court noted that 52 days before the trial, the IRS filed a motion to add a claim under section 2036 whereby the estate should include the value of the FLP’s assets transferred from Strangi. Noting the brevity of the Tax Court’s reasoning for the denial and that the motion to amend was filed two months before the trial, the court found no obvious reason for denial of leave to amend and reversed the Tax Court on that issue.

Settlement Proceeds Subject to Tax Lien

In William H. Murphy Jr. v. Comptroller of the Treasury, 90 AFTR 2d 2002-5033 (DC MD) 06/6/2002, William Murphy, the primary beneficiary and representative of his mother’s estate, brought suit on behalf of the estate and in his individual capacity against the attorney who valued the assets and computed the tax liability of the estate. He claimed that the attorney was professionally negligent in valuing his mother’s estate and in computing the estate’s tax liability and that the estate incurred substantial taxes, penalties, and interest as a result. After a settlement was reached, Murphy argued that he had a superior claim to some or all of the proceeds from the settlement attributable to his individual claims as a beneficiary of the estate.

The Court held that Murphy lacked standing to sue the attorney as a beneficiary of the estate and that the settlement proceeds resulted only from Murphy’s claims on the estate’s behalf in his capacity as personal representative. The court then found that the settlement proceeds were estate property to which the government held a superior claim because of its tax lien.

Trust’s Investment Advisory Fees Subject to 2 Percent Floor

In J.H. Scott, et al. v. U.S., 89 AFTR 2d 2002-1314, (DC VA 02/28/2002), the IRS was granted summary judgment in a taxpayers’/trustees’ and income beneficiaries’ refund action, the court finding that the deduction for financial advisor fees was subject to the 2 percent rule of Code section 67(a). The court held in this case that the fees didn’t qualify as section 67(e) trust administration expenses where they weren’t unique to trust administration. Under Virginia law, trustees are not required to consult with financial advisors, so their retention of a financial advisor was no different than what individual investors would do in a non-trust case.

The court held that Mellon Bank N.A. v. United States, 265 F.3d 1275 (Fed. Cir. 2001) (2001 TNT 176-10), applied, where the Federal Circuit held that an outside financial advisor’s fees didn’t qualify for the complete deduction under section 67(e) because that is available only for administrative expenses that are unique to the administration of a trust and not customarily incurred outside of trusts. The court held that an individual, not bound by a fiduciary duty, would likely incur the expenses when managing a large sum of money. Thus, the advisor’s costs weren’t exempt and were subject to the 2 percent floor. The court rejected the trustees’ reliance on
Tax Update, continued

O’Neill v. Commissioner, 994 F.2d 302 (6th Cir. 1993), finding that they failed to show that they were required to seek investment advice to fulfill their fiduciary duties under state law. Important to the court in this case is the fact that Virginia, where the trust was located, gives a fiduciary absolute immunity from claims that it did not follow the “prudent investor” rule in managing trust assets, provided the fiduciary invests in the assets specified by statute.

Section 2036 Applies to FLP

In Estate of Theodore R. Thompson, et al. v. Commissioner, T.C. Memo. 2002-246, No. 7578-9, the Tax Court has held that although two family limited partnerships formed two years before decedent’s death were valid for tax purposes, decedent retained full enjoyment of his contributed properties to the FLPs and the asset date of death values are includable in his estate under section 2036.

Decedent executed a durable power of attorney appointing his son and daughter as his agents and granting them power to handle his financial affairs. Decedent’s son and daughter met with a financial planner, a financial advisor and an attorney who reviewed decedent’s trust documents and will. The attorney and financial advisor recommended an estate plan using family limited partnerships (FLPs), one for each family. Decedent, his children and son-in-law agreed to form two FLPs and two corporations to serve as general partners.

Decedent contributed $1,286,000 and the notes receivable from his daughter’s family to FLP One. Decedent contributed $1,118,500 and notes receivable from son’s family to the FLP Two. Prior to decedent’s death, the FLPs distributed a total of almost $100,000 to decedent so that he could make gifts to family members and pay personal expenses. The distributions were shown on his Schedule K-1 as a distribution and a reduction in his capital account. Decedent made gifts of FLP interests as well in the two years prior to his death. Gift tax returns were filed reporting adjusted taxable gifts for the FLP interests. At his death decedent held a majority interest in both FLPs and in the corporate partner. A Form 706 estate tax return was filed, reporting a combined $1.7 million value for the decedent’s limited partnership interests and claiming a 40% combined discount for minority interest and lack of marketability. The IRS issued a deficiency notice determining a $707,054 deficiency in estate tax, increasing the values of the estate’s interests in the FLPs to $3.1 million and increasing the amount of taxable gifts related to decedent’s lifetime gifts of limited partnership interests.

The Tax Court held that the FLPs were valid under state law and had sufficient substance to be recognized for tax purposes. However the court concluded that decedent had retained sufficient possession, enjoyment, and the right to the income from the property transferred to the FLPs to require inclusion in his estate under section 2036(a)(1). The court noted that the circumstances around the FLPs’ establishment showed that there was an agreement that he would retain the enjoyment of the property.

The court rejected the argument that section 2036(a) didn’t apply because the transfers to the FLPs were bona fide sales for an adequate and full consideration. The court concluded that the FLP was merely a vehicle to change the form in which decedent held his property and that the receipt of the partnership interest for the assets wasn’t full consideration under section 2036. The court concluded (i) the date-of-death value of the assets decedent transferred to the FLPs was includable in his estate, (ii) new assets held by the FLP One were includable in decedent’s estate, as the bulk of the assets in the partnership came from his initial contribution or income from the contribution (iii) none of the new assets held by FLP Two were derived from decedent’s contribution, and (iv) the gifts of FLP interests that decedent made had no separate value.

Charitable Deduction Reduced By Taxes

In Estate of Marion P. Bradford v. Commissioner, T.C. Memo. 2002-238, No. 4659-00, the Tax Court has held that an estate must determine the amount of the charitable deduction available to the estate after the deduction of debts, expenses, and taxes.

After the payment of bequests under decedent’s Will, the residue of the estate was distributed to the trustee of decedent’s revocable trust. One half of the trust residue was to be given to a charitable foundation. The Will provided that if the probate estate was insufficient to pay debts, expenses, and death taxes, the executor could apply to the trustee for payment. The estate filed an estate tax return, claiming a charitable deduction and later filed an amended return reporting a reduced charitable deduction. The IRS issued a deficiency notice, determining that the estate was entitled to a further reduced charitable deduction, having computed the charitable deduction

continued on page 22
Tax Update, continued

after deducting the death taxes, and debts from the assets available for distribution.

The court, looking to state law (North Carolina), concluded that state law apportions estate taxes to all persons with interests in the estate. Charitable bequests are exempt from apportionment, unless a different method is specified in the Will. Because the Will directed that the death taxes be paid from the residuary estate and that they be borne without apportionment, that controls. The court concluded that any death taxes certified under the Will for payment from the trust were to be paid before the trust property was allocated between the trust beneficiaries and the amount of the charitable deduction was accordingly reduced.

Court, On Remand, Determines Value Of Claims Against Estate

In Estate of Elizabeth P. O’Neal, et al. v. United States, 90 AFTR 2d 2002-6280 (DC AL 07/31/2002), in 1987 decedent and her husband made gifts of closely held stock to their children and grandchildren. They filed gift tax returns, valuing the stock under an existing buy-sell agreement. Decedent’s husband died the next year. After the statute of limitations had expired, the IRS asserted that the value of the stock was understated and asserted transferee tax liability against the children and grandchildren for gift taxes and penalties for $9.4 million.

Following decedent’s death and after a petition had been filed with the Tax Court contesting the liability, the IRS and the descendants reached a settlement fixing the liability at $563,314. The descendants sought reimbursement from the estate which the Alabama probate court ordered. The estate then filed amended estate tax returns, claiming a deduction for the descendants’ claim. The IRS failed to act and the estate filed a refund suit in district court which held that the estate was entitled to a deduction for the transferee liability claims but the deduction was limited to the amount of the Tax Court settlement.

The Eleventh Circuit held that the claim was to be valued as of the date of decedent’s death, stating that post-death events, such as the Tax Court settlement, were to be disregarded. and remanded the valuation issue to the district court. On remand, the district court, noting that the government failed to offer evidence to determine the claim’s value, followed the conclusions of the estate expert who based the value of the claim on the possible outcomes of the transferee tax litigation (based on the facts known at the time of decedent’s death) and concluded that the value of the descendants’ claim as of decedent’s date of death was $5.8 million. The deduction was reduced under section 2053(c)(2) to $5.3 million and because the deduction reduced the taxable estate to zero, the estate was entitled to a $2.1 million refund, the estate taxes paid.

II. REVENUE RULING
Guidance on CRT Payments to Trust for Disabled Beneficiary

In Rev. Rul. 2002-20; 2002-17 IRB 794, the Service has issued guidance, superseding Rev. Rul. 76-270, 1976-2 CB 194, on when a charitable remainder unitrust may pay the untrust amounts to a second trust for the life of an individual who is financially disabled.

In general, a charitable remainder unitrust may pay untrust amounts to a second trust only for a term of 20 years or less. However, a trust may qualify as a charitable remainder unitrust under section 664 if the untrust amounts will be paid for the life of a financially disabled individual to a separate trust that will administer these payments on behalf of that individual and, upon the individual’s death, will distribute the remaining assets either to the individual’s estate or, after reimbursing the state for any Medicaid benefits provided to the individual, subject to the individual’s general power of appointment.

Under these circumstances, the use of the assets in the second trust during the disabled beneficiary’s life and at his death is consistent with the manner in which the beneficiary’s own assets would be used. The disabled beneficiary, therefore, is considered to have received the untrust amounts directly from the charitable remainder unitrust for purposes of section 664 (d)(2)(A). Accordingly, the term of the charitable remainder unitrust may be for the life of the disabled beneficiary and is not limited to a term of years. The same result will apply if the original trust is a charitable remainder annuity trust.

III. IRS PRIVATE LETTER RULINGS AND TECHNICAL ADVICE MEMORANDA

Charitable Deduction Allowed for Gift to Foreign Private Foundation

In PLR 200226012, continued on page 23
**Tax Update, continued**

Taxpayer, a citizen of a foreign country and a permanent resident of the United States, established a private foundation in her foreign country to promote charitable purposes. She requested a ruling that the proposed contribution to her foreign private foundation would qualify for a gift tax charitable deduction under section 2522.

Under the facts of the ruling taxpayer contributed cash and an undivided interest in property to the foundation. Taxpayer would be the only person making contributions to her private foundation. Pursuant to the foundation’s charter, the foundation’s voting rights would be exercised only by a special representative. Furthermore, the foundation’s Board of Trustees would make all decisions regarding distributions for charitable purposes. Neither the taxpayer nor the taxpayer’s relatives or subordinates would be permitted to serve as special representative or on the Board of Trustees.

The Service held that under these facts the transfers to the foreign private foundation were permissible under section 25.2522(a)-1(a) which provides that a private foundation need not be a domestic foundation in order to qualify for a gift tax deduction. Therefore, the Service ruled that taxpayer’s transfer of property to her newly created foreign private foundation would qualify for a gift tax charitable deduction under section 2522.

**Late GST Allocation Relief Allowed**

In *PLR 200227017*, a husband and wife established an irrevocable trust for the benefit of their children and descendants. They made transfers to the trust for three years, filing federal gift tax returns, prepared by their accountant that reported the transfers to the trust, but didn’t allocate GST exemption to the transfers in the first two years. After wife’s death, the executor of her estate and the husband sought an extension of time under Reg § 301.9100-3 to allocate GST exemption to the first two years’ transfers.

The Service ruled that the husband and wife acted reasonably and in good faith and concluded that the requirements of Reg. § 301.9100-3 had been satisfied and granted Husband and Wife’s executor an extension of time of 60 days to make the allocations, effective as of the various dates of the transfers to the trust that occurred in the first two years.

**IRA Payable to Charity in Return for Gift Annuity**

In *PLR 200230018*, the Service has ruled that a charity’s tax exempt status will not be adversely affected by the receipt of IRA proceeds on an individual’s death in exchange for an annuity payable to another person. Additionally, under these facts the charity will not recognize unrelated business taxable income as a result of its receipt of the proceeds from the IRA.

In consideration for the testamentary gift of his individual retirement account to the charity’s general fund, the charity will pay an annuity to another person, if she survives the individual. If that person predeceases the individual, the IRA proceeds will be transferred to the charity without any obligation on the charity’s part. The annuity is irrevocable and non-assignable, cannot be commuted, and is to be paid from the charity’s general fund. The amount of the annuity payout will be based on the amount contained in the IRA at the individual’s death, the recipient’s age at that time, and the gift annuity rates in effect at the individual’s death.

The Service ruled that (i) the value of the IRA at the individual’s death will be included in his gross estate, (ii) an estate tax charitable deduction will be allowed to his estate equal to the value of the IRA on the date of death less the present value determined as of the date of death of the annuity payable to the individual, and (iii) the proceeds distributed to the charity from the IRA will be items of income in respect of a decedent to the charity when distributed and will not be income in respect of a decedent to the individual’s estate.

**Executor May Allocate to Charity Proceeds of IRA Payable to Estate**

In *PLR 200234019*, a decedent’s estate was named as the beneficiary of several IRAs owned by the decedent. The decedent’s will divided the estate between named charities and individuals. The total value of the IRAs was approximately the charities’ share of the estate, and the executor proposed assigning the IRA accounts to the charities. The Service ruled that the assignment of the accounts would not cause the estate or the named beneficiaries to have taxable income. The Service also ruled the assignment would not cause any amounts to be included in the estate’s DNI. Lastly, the Service concluded that the charities would

---

*Probate and Trust Law Section Newsletter No. 105* 23
Tax Update, continued

realize income in respect of a decedent, but the income would not be taxable.

IRS Allows Extension of Time to Sever Trusts and Make Reverse QTIP Election

In PLR 200215026, a husband died survived by his wife, children, and grandchildren. A revocable trust created by the couple provided that at the husband’s death, the trust would be divided into three trusts: a survivor’s trust, a tax credit trust and a QTIP trust. After funding the survivor’s trust, the remainder of the funds were used to fund the QTIP trust. The estate filed a timely Form 706, making a QTIP election for the QTIP trust but failed to make a reverse QTIP election and also failed to allocate the husband’s remaining GST exemption.

Because the husband’s remaining GST exemption was insufficient to extend to all of the assets of the QTIP trust, the estate petitioned a local court which issued an order to divide the QTIP trust into two trusts, a GST exempt trust, funded with assets equal to the value of husband’s unused GST exemption, and a GST nonexempt trust for the balance. The estate requested an extension of time to sever the trust into GST exempt and nonexempt trusts and to make a reverse QTIP election for the GST exempt trust.

Under these facts, the Service ruled the requirements of Reg. sections 26.2654-1 and 301.9100-3 were satisfied and granted the extension. However, the Service noted that an extension of time to make the reverse QTIP election under section 2652(a)(3) doesn’t extend the time to allocate any remaining GST exemption.

Commutation of Charitable Trust Leaves Beneficiary With No Basis under Section 1001(e)

In PLR 200231036, under the terms of a decedent’s will, a residuary trust was established for the benefit of the decedent’s grandson. The grandson was to receive income from the trust each year during his life, and upon his death the remainder of the trust would be divided among four charities. In the first year following the decedent’s death, the investments in the trust were restructured pursuant to a court order, with the grandson to receive a minimum amount, and the remainder to be paid to the charities in a lump sum.

A dispute then arose over the continuing administration of the trust, and the parties entered into an agreement to resolve the dispute. Under the proposed agreement, which was to be submitted for court approval, the excess of the trust would be distributed to the charities, and their interests in the trust would terminate. The remaining assets in the trust would continue in trust for the benefit of the grandson, and on the grandson’s death the corpus of the trust would be distributed pursuant to his exercise of a general testamentary power of appointment. Any portion not effectively appointed, would be distributed to grandson’s surviving descendants free of trust.

The Service ruled that the right of the grantor’s spouse to receive annuity payments was not fixed and ascertainable, but contingent upon the grantor’s death prior to the end of the term. The spouse’s interest was essentially the same as the spousal interest considered in Cook v. Commissioner, 269 F.3d 854 (7th Cir. 2001), affirming 115 T.C. 15 (2000), and Schott v. Commissioner, T.C. Memo 2001-110, where the courts determined that the only qualified interest retained by the grantor was the individual right to receive an annuity for a term of years or the grantor’s prior death. Furthermore, the Service ruled that, contrary to the

Revocable Spousal Interest Ignored in Valuing Gift to GRAT

In TAM 200230003, a husband and wife each created and funded two GRATs with stock in a closely held business. Under the terms of each GRAT, if the grantor dies before the end of the term and the grantor’s spouse survives the grantor without his or her interest having been revoked, he or she would receive the remaining annuity payments. If the grantor dies before the end of the term and spouse was predeceased or spouse’s interest had been revoked, the remaining trust assets would be paid according to grantor’s general power of appointment, or if not effectively appointed, to the grantor’s estate. The grantors filed Forms 709, reporting the remainder interest in each GRAT as taxable gifts. The grantors calculated the value of the retained interest for each trust as the present value of an annuity for a term of years or the prior death of the grantor and the grantor’s spouse.

The Service ruled that the right of the grantor’s spouse to receive annuity payments was not fixed and ascertainable, but contingent upon the grantor’s death prior to the end of the term. The spouse’s interest was essentially the same as the spousal interest considered in Cook v. Commissioner, 269 F.3d 854 (7th Cir. 2001), affirming 115 T.C. 15 (2000), and Schott v. Commissioner, T.C. Memo 2001-110, where the courts determined that the only qualified interest retained by the grantor was the individual right to receive an annuity for a term of years or the grantor’s prior death. Furthermore, the Service ruled that, contrary to the
Tax Update, continued

taxpayers' argument, even if the
GRATs could be interpreted to provide for payment of the
remaining annuity to the Grantor's
estate or pursuant to a general power of
appointment, the trusts were not
fixed term GRATs within the
purview of the Walton decision.
Here, the estate's annuity interest
would be payable to the estate only
if either the spouse predeceased the
Grantor or the Grantor revoked the
spousal interest.

Partition of a QTIP Trust and
Partial Termination Not a Gift of
Property in Remaining Trusts

In PLR 200230017, the
residue of decedent's estate was
distributed to a marital trust for his
wife's benefit, for which the executors
made a QTIP election. On the wife's
death, the trust was to be distributed
to seven of decedent's descendants.
To resolve a disagreement among
the beneficiaries and the trustees over
investment strategies, a settlement
was reached, pursuant to which the
QTIP trust was divided into separate
trusts for each of the seven remainder
beneficiaries. Each trust was funded
with a pro rata portion of the property
in the QTIP trust based on each
remainder beneficiary's interest in the
QTIP trust. The wife then sold her
qualifying income interest in one of
the separate trusts to the remainder
beneficiary for its actuarial value. The
trust then terminated and the property
was distributed to the remainder
beneficiary outright.

The Service ruled under
these facts that (i) the wife would not be
deemed, under section 2519, to
have made a gift of the property in the
remaining separate trusts; (ii)
assuming that the trustees of the
separate trust that was terminating pay
all state and federal taxes attributable
to the transfer, the amount of the wife's
section 2519 transfer will be reduced by
the gift taxes paid under section
2207A(b); (iii) on the termination of the
separate QTIP trust and the
payment of all state and federal gift
taxes under section 2207A(b), the
value of the wife's section 2519 gift
will be reduced by the gift taxes paid;
(iv) on termination of the separate
QTIP trust, the value of the wife's
income interest in the remaining
separate marital trusts will not be
valued at zero under section 2702 and
the amounts that the wife actually
receives for her qualifying income
interest in the property of the
terminated separate marital trust
won't be valued at zero, and (v)
because decedent died more than one
year prior to the proposed sale of
wife's qualifying income interest in
the separate trust, any income to the
wife from the sale is a long-term
capital gain under section 1222(3).

Gift Of Art Qualifies As Charitable
Contribution

In PLR 200223013, married
taxpayers who own a collection of
artworks, want to establish an art
collection at a museum, with some
works to be donated to the museum
while others are to be loaned. The
arrangement is to be governed by a
gift and loan agreement that sets
guidelines for the museum's display
of the works and also restricts the
couple's ability to transfer the works.
A ruling was requested on the
income, gift, and estate tax
implications of this arrangement.

The Service determined that
(i) the execution of the gift and loan
agreement by itself would not
constitute a completed gift of the
artwork, (ii) any transfer of an
undivided fractional interest in any
work would qualify as a charitable
contribution under section 170(c) and
a completed gift for purposes of the
gift tax deduction under section 2522,
(iii) any loan of items to the museum
by taxpayers will not be treated as a
transfer for gift tax purposes under
2503 (g), and (iv) only individual
fractional interests in the artwork
retained by either taxpayer at death
would be includable in taxpayer's
gross estate.

continued on page 26
Tax Update, continued

Foundation May Own And Pay Premiums On Donor’s Life Insurance Policy

In PLR 200232036, the trustee of an irrevocable trust established by the founder of a private foundation planned to transfer ownership of a term-life insurance policy on the life of the founder to the foundation. Once the transfer of ownership of the policy to the foundation was accomplished, the foundation would name itself as beneficiary using a Change of Beneficiary Form. The acceptance of the policy by the foundation was conditioned on the founder’s written promise to make contributions sufficient to cover all premiums on the policy, and execute an irrevocable voting proxy in favor of another of the foundation’s board directors so that he would have no control over any decisions concerning the policy.

The Service ruled on these facts that (i) the foundation’s acceptance of the policy would not constitute self-dealing under section 4941 nor would the founder’s promise to contribute funds for future premiums and (ii) the foundation would not jeopardize its tax-exempt status by making premium payments on the founder’s term policy because the foundation would have complete ownership and control over the policy.

Disclaimer Of Pre-1977 Trust Interest Valid

In PLR 200238039, settlor had in 1955 created an irrevocable trust for the benefit of his daughter and her descendants. The trust was to terminate 20 years after the death of the last to die of settlor’s descendants living at the time the trust was executed. A great grandchild of the settlor, a current trust beneficiary to whom the trustees may, in their discretion, make distributions, proposed to disclaim her right to receive any distributions from the trust on the trust termination. She had in fact previously received discretionary distributions from the trust and did not intend to disclaim her right to continue to receive such discretionary distributions. Her disclaimer of the right to receive a distribution on the termination of the trust would be executed within nine months after attaining her majority. The Service, citing the state law which specifically provided that an individual may make a valid disclaimer of any separate interest in property while retaining other separate interests in the same property and Treas. Reg. § 25.2511-1(c) governing pre 1977 transfers, ruled that the disclaimer, if properly executed, would not be a transfer subject to gift tax.

Section Events

March 4, 2003
Planning for Disability--An Overview for the Probate and Estate Planning Practitioner
Faculty: Thomas Begley, Jr.
Location: Temporary location TBA
Time: 11:45 a.m. (registration) to 2:30 p.m.

June 3, 2003
Managing Real Estate in Fiduciary Accounts
Faculty: TBA
Location: PBI/PBEC Education Center, Wanamaker Building
Time: 11:45 a.m. (registration) to 2:30 p.m.

October 7, 2003
New Split Dollar Requirements and Other Insurance Issues (working title)
Faculty: TBA
Location: PBI/PBEC Education Center, Wanamaker Building
Time: 11:45 a.m. (registration) to 2:30 p.m.
Philadelphia Estate Planning Council
Calendar of Events

January 21, 2003
11:45 A.M. - 2:00 P.M.
Charitable Gifts of Business Interests

Speaker: Laura Peebles, Partner
Deloitte and Touche, Washington, DC
Sponsor: Jewish Federation of Greater Philadelphia
Location: Union League, Philadelphia
Member Cost: $30
Guest Cost: $40

February 18, 2003
11:45 a.m. - 2:00 p.m.
Six Dimensions of Enterprising Families

Speaker: Tim Habbershon, Director
Wharton Family Controlled Corporation Program, Philadelphia, PA
Sponsor: AMC Capital Partners
Location: Union League, Philadelphia
Member Cost: $30
Guest Cost: $40

March 18, 2003
11:45 a.m. - 2:00 p.m.
Ethics and Investing

Speaker: Thomas A. Bowman, CFA
Association of Investment Management
Location: Union League, Philadelphia
Member Cost: $30
Guest Cost: $40