

McDonald & Kanyuk, PLLC

The New Hampshire Unitrust Conversion Statute: Panacea or Pandora's Box?

Governor Shaheen recently signed into law HB 1217, adding a unitrust conversion provision to the New Hampshire Uniform Trustees' Powers Act. The new law will allow trustees of New Hampshire "income rule" trusts to avoid the tax and investment constraints of the common law duty of impartiality through an expedited non-judicial reformation process which allows for virtual representation. This will enable trustees to avoid expensive probate court proceedings and guardians *ad litem*, but creates some fiduciary dilemmas. This newsletter will discuss the new legislation in detail, issues trustees must confront both now and in the future, and how we at McDonald & Kanyuk can help.

Summary of the Unitrust Conversion Statute

The unitrust conversion statute, codified at RSA 564-A:3-c, is taken almost *verbatim* from a unitrust conversion statute currently pending in the Pennsylvania legislature except that New Hampshire uses a 5% unitrust percentage rather than Pennsylvania's proposed 4% rate. Our statute is effective on January 1, 2003.

The new law allows a trustee to convert an existing "income rule trust"* to a 5% unitrust by a simple notification process. The conversion is final if no beneficiary objects within sixty days of the trustee's notice of conversion. The trustee has broad discretion to make decisions concerning many of the conventions and rules affecting the administration of the trust, such as the effective date of the conversion, the frequency of distributions during the calendar year, the treatment for a short year and accounting for personal use property. No time limits are imposed on the conversion, and with court approval the trustee can select a lower payout percentage, adopt a "smoothing" period different from the three year rule prescribed, or

* The defining feature of an income rule trust is that the governing instrument requires the distribution of the trust's net income at least annually to one or more income beneficiaries, regardless of whether the document also allows for principal invasions. Income rule trusts are to be distinguished from trusts which give the trustee discretion to distribute or accumulate net income.

convert from a unitrust -- presumably back to a traditional income rule trust if future circumstances warrant it. Trustees of marital trusts and "effective date" GST arrangements can convert without fear of adverse federal wealth transfer tax consequences because the statute satisfies the requirements of the IRS's Proposed Regulations governing statutory unitrust conversions. An important ordering rule allows inclusion of the unitrust's net long-term capital gain in the trust's "distributable net income" ("DNI"), thereby potentially shifting those gains from the trust's 1041 to the unitrust distribution recipient's 1040.

Trustees of New Hampshire income rule trusts will be under immediate pressure from income beneficiaries and perhaps their counsel to convert under the statutory notice procedure, but this is by no means a "no-brainer" for the trustee who must consider whether conversion is in *all* beneficiaries' best interests and consistent with the settlor's intentions. Given the high 5% statutory payout rate and the opportunity to choose a lower rate with court approval, trustees face potential surcharge liabilities to remainder beneficiaries for uncritically deciding to convert. Conversely, those who ignore the new law and continue under the income rule have exposure to both income and remainder beneficiaries if in hindsight the trustee's inaction is determined to be arbitrary or unreasonable. Trustees can take several steps to manage these risks by building a record of due diligence which will defend their decisions. Such a record might include computer modeling of expected post-conversion trust performance using "Monte Carlo" simulations, advising beneficiaries of their objection remedy and the potential risks and benefits of conversion, and encouraging them to seek independent advice concerning their obligations to protect themselves and the beneficiaries they virtually represent.

We at M&K are prepared to assist New Hampshire trustees in addressing these issues and building a record to defend a decision to convert or not to convert should it be challenged by a court or beneficiaries. Call Joe McDonald at (603) 228-9900 if you have any questions about the new statute or if you wish to arrange an appointment to discuss how we might help you address these issues.

The Statute in Detail

The Notice Procedure

In determining whether the conversion will enable the trustee to better serve the settlor's intentions and the purposes of the trust, the statute encourages the trustee to consider a nonexclusive list of factors including the trust's size, nature, estimated duration and liquidity and distribution requirements, and the expected tax consequences of the conversion. Other factors suggested for consideration include the nature of the assets in the trust (financial assets, closely-held business interests, tangible personal property or real estate), whether trust assets are being used by a beneficiary, the needs of the beneficiaries for present and future distributions authorized or required by the governing instrument, the extent to which the governing instrument authorizes principal invasions or accumulations of income and the trustee historically has exercised those powers, and the actual and anticipated effect of economic conditions, including inflation and deflation, on the trust's income and principal.

If after considering these factors the trustee intends to pursue the conversion option, the statute requires the trustee to give written notice of such intention and how the unitrust will operate to all *sui juris* (i.e., adult and not legally disabled) beneficiaries who (i) are currently eligible to receive the trust's income, and (ii) would receive, if no powers of appointment were exercised, a distribution of principal if the trust were to terminate immediately before the date of the trustee's delivery of the notice of intent to convert. The conversion will be complete if there is at least one *sui juris* beneficiary in each of these two statutorily-defined classes of income and tentative remainder beneficiaries and no beneficiary objects in writing during an objection period ending sixty days after the mailing of the trustee's notice.

Thus, the statute combines features of private (i.e., non-court supervised) trust reformation and what has been referred to as "horizontal" and "vertical" virtual representation -- legal doctrines which have taken hold in more progressive jurisdictions but are not yet a part of New Hampshire trust law. Virtual representation refers to the ability of one or more competent beneficiaries in a defined class -- and not a court-appointed guardian *ad litem* ("GAL") -- to represent the interests of their non-*sui juris* beneficiaries who might be minors, legally incapacitated or unborn or unascertained. The law allows comprehensive virtual representation by permitting all *sui juris* income and tentative remainder beneficiaries to represent both the non-*sui juris* and unborn concurrent (horizontal virtual representation) and successive (vertical virtual representation) beneficiaries.

The availability of this expedited, low-cost procedure will encourage some trustees to pursue unitrust conversion where they might not have already done so out of concerns for the costs and delays which would attend a probate court-supervised equity action and a GAL appointment under prior law. It should reduce the number of trust modification actions trustees might otherwise file in the probate court as the "total return trust" movement continues building momentum in New Hampshire and nationwide.

For those trusts with trustees unable or unwilling to use the short form notice alternatives, the law outlines procedures for probate court-approved unitrust conversions where (i) a beneficiary timely objects to a notice of intended conversion, (ii) there are no *sui juris* income and remainder beneficiaries to receive a trustee's notice, (iii) at least one trustee is not also a beneficiary, and (iv) a beneficiary petitions for conversion. The probate judge must approve or direct conversion if he or she concludes that the conversion will allow the trustee to better carry out the settlor's intentions and the trust's purposes. Although the statute does not address this issue, it appears that no virtual representation will be available under the court-approved alternative, and a GAL almost certainly will be required in most cases.

Technical Federal Tax Issues: Marital Deduction Qualification, and Effective Date Generation-Skipping Arrangements

RSA 564-A:3-c is part of a trend among state legislatures to adopt total return trust legislation. Such legislation allows equitable adjustments or unitrust conversions which will redefine state fiduciary accounting income principles to allow trustees of income rule trusts to pursue total return investing where it would otherwise be proscribed or inhibited by the common law duty of impartiality owed to the successive classes of beneficiaries of income rule trusts.

In response to this movement, the Treasury Department issued Proposed Regulations in February, 2001 to revise the definition of "income" for federal income tax accounting purposes under Code §643(b). These regulations specify that state laws providing payment to an income beneficiary of a unitrust amount of between 3% and 5% of the annual value of the trust is a reasonable apportionment of the trust's total return among the successive beneficiaries. The effect of the Regulations is to allow unitrusts and equitable adjustment trusts to meet the "all income requirement" which applies to marital QTIP and general power of appointment trusts, and to preserve the "grandfathered" status of effective date GST trusts for those conversions or adjustments made according to a state statute specifically authorizing them.

Our statute's adoption of a 5% unitrust percentage is within the Regulations' safe harbor, so trustees of marital trusts and effective date GST arrangements — generally, trusts which were irrevocable or could not be amended before the 1986 effective dates of the GST legislation — can convert them without fear of losing their transfer tax-favored status or, for marital trusts, requiring a distribution to the surviving spouse in an amount equal to the greater of net income and a 5% unitrust amount.

Ordering Provision: the "WIFO" Rule

Our conversion statute incorporates an important "ordering rule" that is favorably considered in the Proposed Regulations. This means that the 5% payout should carry out with it capital gains (short and long-term, in that order) as K-1 income to the beneficiary to the extent needed to comprise the full unitrust payout -- essentially the same tax accounting procedure applicable to charitable remainder trusts and sometimes referred to as the "WIFO" rule (worst in, first out). Allocating capital gains to income allows our conversion statute to state the unitrust payout percentage at the high end of the Regulations' safe harbor without impairing the remainder interest to the same de-

gree as under the previous rules for determining a trust's DNI for federal income tax reporting purposes. Those rules generally allocate all capital gains to principal, taxable to the trust, and do not carry them out to the income beneficiaries as part of the DNI computation. Depending upon the cost basis of the trust investments and the degree of turnover in the portfolio, a 5% unitrust distribution from a converted unitrust trust which carries out capital gain would roughly be equivalent to a 4.3% distribution for a low cost basis portfolio or a 4.75% distribution for a high cost basis portfolio if capital gains taxes were paid by the trustee.

Observations and Caveats

In many respects the adoption of the unitrust conversion statute will be a very welcome development for trustees and beneficiaries of New Hampshire income rule trusts, particularly trustees and beneficiaries of long-term "pure" income rule trusts -- those allowing no principal invasions. It is hard to imagine an income beneficiary of a \$1 million converted pure income rule trust complaining that his annual \$25,000 distribution of ordinary income has increased to \$50,000, \$35,000 of which is taxed as long-term capital gain, increasing his after-tax amount by some \$25,860 (assuming the beneficiary is in the maximum marginal income tax bracket). Those commentators who champion unitrusts over income rule trusts speak convincingly of how, in an investment environment where capital appreciation is increasingly favored over current income yield, a unitrust conversion will align the interests of income and remainder beneficiaries. It will unshackle the trustee from the common law duty to serve the interests of both income and remainder beneficiaries by balancing the trust's investments between fixed income and equity securities, enabling the trustee to pursue total return by achieving equity-favored asset allocations determined for the right reasons (i.e., the liquidity requirements of the trust, the nature and purposes of the trust, risk tolerance, etc.), not because of the artificial distinctions the law makes between fiduciary accounting income and principal.

There are, however, some lingering concerns our statute fails to address for fiduciaries.

Many states adopting total return trust legislation have added procedures to safeguard from liability the trustees who make unitrust conversions or equitable adjustments. For example, all equitable adjustment jurisdictions allow for trustee action without notice to beneficiaries, but California also allows for a notice procedure and a beneficiary objection remedy, specifically insulating the trustee from liability for any adjustment if the beneficiary fails to object, and providing that a beneficiary's sole remedy in a proceeding contesting a trustee's exercise or non-exercise of the adjustment power is for the court to direct, deny or revise the adjustment, thereby expressly eliminating the personal surcharge remedy from consideration. New York's unitrust conversion statute similarly protects the trustee against surcharge unless the court finds that the trustee was dishonest or arbitrary. Our statute makes no such provision.

Perhaps our statute's drafters determined that an express exoneration provision was unnecessary given the requirement that a beneficiary who receives notice, and those beneficiaries who he or she virtually represents, must object within the statutory period or forever hold his or her peace.

Many cautious trustees, however, will not be comfortable relying only on this implied safe harbor alone. One way to address such concerns is to petition the court to approve the conversion at the 5% rate. The court, however, may require the trustee to absorb all of the costs of such an action because costs incurred only for the protection of the trustee generally cannot be paid from the trust estate. Trustees deciding not to pursue court approval might consider building a record of reasonableness and prudence by making specific findings in support of the exercise of the discretion on each of the factors listed in the statute which the trustee is encouraged to consider.

These findings might include, for example, spreadsheets comparing over the expected duration of the trust the anticipated performance of the 5% unitrust, unitrusts with payout percentages between 3% and 5%, and the income rule trust. Software is available which uses Monte Carlo simulations (which randomly generate values for uncertain variables over and over to simulate a model) to incorporate real world elements of chance and randomness. These computer programs enable the user to model possible outcomes by incorporating various scenarios which reflect the historical volatility and uneven performance of the equity and fixed income markets, different asset allocations and rates of portfolio turnover, taxes (including income taxes based on the WIFO rules), fees, expenses and other factors.

Computer modeling and simulation analysis will enable the trustee to determine whether the statutory 5% unitrust amount is too high to protect the purchasing power of the remainder interest through the expected duration of the trust. Some commentators have questioned whether, particularly for long-term trusts, a 5% payout tends to shift a portion of the remainder interest to the income beneficiary in a manner inconsistent with the settlor's presumed intent -- particularly if the trust is designed as an "income only" arrangement with no principal invasion powers.

After completing this rigorous analysis, many trustees undoubtedly will conclude that they are uncomfortable with their surcharge exposure. Such trustees have options:

- ◆ Proceeding with the conversion, but making full disclosure to the beneficiary of:
 - the trustee's misgivings about the 5% payout rate;
 - the trustee's computer modeling which shows that under some of the scenarios tested, the real purchasing power of the principal is not preserved; and
 - the beneficiaries' obligation to represent and protect both their own interests *and* the interests of the non-*sui juris* and unborn remainder beneficiaries.

The text of the notice also might urge the beneficiaries to seek independent advice to determine whether they should exercise their objection remedy on behalf of themselves and their virtual representees. If a trustee is to rely on the beneficiary objection remedy and its implied safe-harbor as a liability insulator, it is the trustee's obliga-

tion to ensure that the beneficiary has all information necessary to determine whether to assert that remedy. Belt and suspenders: once the conversion is complete the trustee can report the conversion on the next fiduciary accounting and for added protection rely on the accounting provisions of the trust document or the formal probate accounting for testamentary trusts. Most boilerplate accounting provisions prescribe their own objection periods, often providing a very short (typically 30 or 60 days) limitations period for beneficiary challenges to any trustee actions reflected in the accounting.

- ◆ If the trustee's misgivings about the 5% payout rate are so grave that the trustee determines that conversion is not in the best interests of the beneficiaries or consistent with the settlor's intention, the trustee might:
 - Petition the probate court to allow conversion to a lower percentage (e.g., 3% or 4%) unitrust; or
 - Notify the beneficiaries of the statutory conversion option and trustee's analysis establishing the basis of the trustee's decision not to proceed with conversion, informing the beneficiaries of their rights under the statute to petition the probate court for a conversion, in which case the trustee can make its case to a court and perhaps convince the court to convert but at a lower percentage.

How We Can Help

We have studied the statute in great detail and given a lot of thought to how we can help trustees who must confront these difficult issues. We have developed a procedure for analyzing conversions in any given instance, including forms for a general policy concerning conversion decisions for trustees of multiple income rule trusts; tools for a trust-by-trust analysis, including computer modeling software, to be used in deciding whether to convert, and which unitrust percentage might be best given the unique circumstances of the trust arrangement, and a form for "Notice to Beneficiaries" of a decision to convert which describes the basis for the decision, the proposed rules, conventions and procedures for the trust's administration, and a statement of the beneficiary's rights to challenge the trustee's determination under the statute. We can help to develop procedures to monitor converted unitrusts going forward to ensure that changed circumstances do not create a risk that the chosen percentage will inappropriately shift some of the remainder beneficiary's interest to the income beneficiaries in a manner inconsistent with the settlor's presumed intentions. Feel free to contact us if you would like to discuss this in more detail and explore how you might use these services.

This publication is not intended to be legal advice. Counsel should be retained for individual estate planning and legal advice. The New Hampshire Rules of Professional Conduct may require this newsletter to be labeled "advertising".