[ALTERNATIVE A]

[ARTICLE] 6

EQUITABLE ADJUSTMENTS

SECTION 601. TRUSTEE'S POWER TO REALLOCATE

(a) If after applying ~~the foregoing provisions~~ [Articles] 1 through 5 of this [Act], the trustee determines that to comply with § 102(a) it is necessary to reallocate between income and principal, the trustee may reallocate in whole or in part in such manner and in such proportions as the trustee determines.

(b) In exercising the power of reallocation, a trustee shall consider, in addition to other relevant factors, such of the following factors, among others, as the trustee ~~deems~~ considers relevant to the trust or its beneficiaries:

(1) the nature, purpose and expected duration of the trust;

(2) the express intent of the settlor;

(3) the identity and circumstances of the beneficiaries;

(4) the actual and expected effect of economic conditions on principal and income and the possible effect of inflation and deflation;

(5) the expected tax consequences of a reallocation;

(6) the total return from investments;

(7) needs for liquidity, regularity of income, and preservation or appreciation of capital;

(8) the presence or absence of a power to invade principal or other dispositive provisions, that would reduce the importance of a reallocation, and the apparent reason for the presence or absence of such a provision; and

(9) the assets held in the trust.

[ALTERNATIVE A]

(c) The trustee may not make a reallocation pursuant to subsection (a) that would cause a loss, of all or part, of any federal or state gift tax exclusion, gift or estate tax marital deduction, income, gift or estate tax charitable deduction, or any inheritance tax deduction otherwise available to any estate or trust or to the settlor of a trust or a decedent. In addition, a trustee shall not exercise the power for the trustee's direct or indirect benefit, including the satisfaction or mitigation of any legal obligation of the trustee; however, a disinterested co-trustee may exercise the power.

(d) If a governing instrument limits the power~~s~~ of a trustee to make equitable adjustments, the instrument must not be construed to be contrary to this section unless it is clear from the instrument that it is intended to deny the trustee ~~access to~~ the power of reallocation.

Comment

Purpose and Scope of Provision. *This section~~, also~~ gives trustees the power to deal with extraordinary and unanticipated situations and to overrule unjust results under the standard provisions of the Act.*

Section 3B:19A-32 of the New Jersey, Statutes which was passed by the New Jersey legislature in 1991, allows the trustee faced with extraordinary and unanticipated situations to reallocate. That section takes meaning from section 45a-219 (d) of the Connecticut Statutes.

This section also alleviates the tension between modern rules for investing the assets held by a trustee and traditional ideas about what constitutes the return on a portfolio. As to modern trust investing, see the Uniform Prudent Investor Act (1994).

This section allows the trustee to undertake the best, the most prudent and totally most productive investment of all the trust assets without concern about whether the investments chosen have the effect of impartially allocating the investment return between the income and principal beneficiaries. Both income and principal beneficiaries are entitled to proper return, and the allocation of that return should not have to be a function of the particular assets chosen by the trustee. This section also allows the trustee to follow the well understood traditional system of allocating receipts and expenditures in many situations.

This section is not limited to the trustee who is a modern portfolio theory investor.

If the trustee invests all the assets of a trust, taken as a portfolio, in a way that will have an initially unsuitable effect without a reallocation of return this section allows the trustee to reallocate. The power to reallocate receipts spares the trustee from having to choose second best investments. This power also allows the trustee to deal impartially and effectively with the effect of inflation and deflation on investment returns.

The change -- giving a trustee the power to reallocate portfolio returns between income and principal -- is less dramatic than it might first seem to be. The prior Principal and Income Acts inferentially allowed a range of possible returns for successive beneficiaries via asset choice and asset allocation. There were a number of legally acceptable, impartial portfolios for any given trust that would produce a variety of income and principal outcomes. Consider a hypothetical world in which financial assets invested at a particular level of risk could earn a total return of 8%. The trustee could prudently choose within a universe of portfolios -- for example, a portfolio that provided 5% income and 3% growth or 5.5% income and 2.5% growth or 4.5% income and 3.5% growth. So, the trustee always had the power to affect the return to beneficiaries.

Operating under this section, if the trustee concludes that the outcome of a conventional allocation between principal and income would be unsuitable, then the trustee should reallocate to achieve a suitable result.

Taxes. It is expected that reallocated income will be the income of the trust under the law of any state adopting the Act. It is the intent of the drafters that any capital gains realized to fund a reallocation payment to the income beneficiary shall be allocated to the income beneficiary.

It is hoped the marital deduction will be available under this section of the Act.

Fiduciary duty. This power is subject to an abuse of discretion standard. Reasonable trustee action is not subject to judicial review except to prevent an abuse of discretion. See Restatement (Second) of Trusts § 187 (1959). See also id §§ 183, 232, 233, comment p (1959).

There is an intrinsic tension in trust law between granting trustees broad powers that facilitate flexible and efficient trust administration, and protecting trust beneficiaries from the misuse of such powers. A broad trustee's power, such as those found in most lawyer-drafted instruments and exemplified in the Uniform Trustees' Powers Act, permits the trustee to act vigorously and expeditiously to maximize the interest of the beneficiaries in a variety of transactions and administrative settings. Trust law relies upon the duties of loyalty, impartiality and prudent administration, and upon procedural safeguards such as periodic accounting and the availability of judicial oversight, to prevent the misuse of such powers. Reallocation, which is a species of trustee power, raises the same tension. If the trustee reallocates effectively, the beneficiaries obtain the advantage of the underlying investment and the allocation. But if the trustee reallocates ineffectively the reallocation can do harm.

This section is designed to strike the appropriate balance not only between the advantages and the hazards of reallocation, but also between the advantages and hazards of reworking a known investment/allocation system.

This section is subject to the injunctions in Section 102 of this Act including the one that the trustee "shall be fair and reasonable to all of the beneficiaries unless the governing instrument clearly manifests an intention that the fiduciary must or may favor one or more beneficiaries." This section is also subject to the limitations on fiduciary liability in Section 103.

Default rule. This section is a default rule of trust law. A settlor can expressly set aside this rule, just as a settlor can establish a noncharitable unitrust, instead of a traditional trust, to avoid some of the problems that arise when a trustee invests in a modern fashion within a traditional trust.

Examples. The following examples demonstrate the function of the reallocation approach in the context of modern investing:

Example (1)--T is the trustee of a trust that provides income for a surviving spouse for life, remainder to another. The trust portfolio is 60% invested in a portfolio of stocks or mutual fund that seeks to replicate the performance of the Standard & Poor's 500 and 40% invested in a bond portfolio or mutual fund that seeks to replicate the performance of the U.S. Bond Market as a whole. Trustee paid the traditional income attributable to both funds to the income beneficiary. The trustee is justified in forgoing use of the reallocation power because, historically, the traditional income return on the Standard & Poor's 500 provides a stable, real return on equity principal that is strongly correlated to the Consumer Price Index and because a surviving spouse, can properly be understood as a primary object of the settlor's bounty. Moreover, the traditional return on both parts of the portfolio can be understood as a return that is within the range of appropriate returns allocable to an income beneficiary.

Example (2)--Having invested the entire trust in a stock portfolio designed to replicate the performance of the Standard & Poor's 500 or in a no-load, low-transaction cost mutual fund that passively invests in the stocks in the Standard & Poor's 500 average, the trustee allocates in a traditional fashion under the general terms of the act. The trustee's objective was to keep the income stream smooth and stable, even with inflation, and to preserve the power of the portfolio to produce such a stream of income over an extended period of time. The trustee expected that there would continue to be a correlation between the dividends paid by the S & P 500 and the Consumer Price Index. The trustee is justified in forgoing use of the reallocation power because the traditional income return on the Standard & Poor's 500 meets the stated goals. Moreover, the traditional return on the portfolio can be understood as a return that is within the range of appropriate returns allocable to an income beneficiary. See Twentieth Century Fund, Task Force on College and University Endowment Policy, Funds for the Future 122 (1975) (this is, in its essence, a monograph by J. Peter Williamson); James P. Garland, A Market-Yield Spending Rule for Endowments and Trusts, The Financial Analysts Journal, 50, 53 (July/Aug 1989). See also Robert H. Jeffrey, The Folly of Market Timing, Harv. Bus. Rev., July-Aug 1984, at 102; Robert H. Jeffrey, A New Paradigm for Portfolio Risk, J. Portfolio Mgmt., Fall 1984, at 33.

Example (3)--Having invested in a portfolio that was 60% invested in stocks or a mutual fund that seeks to replicate the performance of the Standard & Poor's 500 and 40% invested in a bond portfolio or mutual fund that seeks to replicate the performance of the U.S. Bond Market as a whole, the trustee paid the traditional income attributable to the S&P 500 fund to the income beneficiary, but capped the traditional income attributable to the bonds, or bond fund, by reference to the Consumer Price Index, adding the balance of the income earned by the bond fund to principal in order to preserve the real value of the principal. The trustee's objective was to keep the income stream smooth and stable, even with inflation, and to preserve the power of the portfolio to produce such a stream of income over an extended period of time. The trustee is justified in forgoing the power of reallocation because the traditional income return on the Standard & Poor's 500 provides a stable, real return on equity principal that strongly correlates with the Consumer Price Index. The trustee is justified in reallocating the traditional income from the bonds, or bond fund, because Consumer Price Index adjustments in payments are understood by many to be an appropriate way for providing for a real return on bonds. See James P. Garland, A Market-Yield Spending Rule for Endowments and Trusts, The Financial Analysts Journal, 50 (July/Aug 1989).

Example (4)--Having invested in a portfolio that was 60% invested in stocks or a mutual fund that seeks to replicate the performance of the Standard & Poor's 500 and 40% invested in a bond portfolio or mutual fund that seeks to replicate the performance of the U.S. Bond Market as a whole, the trustee paid the traditional income attributable to the S&P 500 stocks, or fund, to the income beneficiary, but capped the traditional income attributable to the bonds, or bond fund, at 3%, adding the balance of the income earned by the bonds, or bond fund, to principal in order to preserve the real value of the principal. The trustee's objective was to keep the income stream smooth and stable, even with inflation, and to preserve the power of the portfolio to produce such a stream of income over an extended period of time. This was done during a period when there was a strong correlation between the dividends paid by the S & P 500 and the Consumer Price Index. The trustee is justified in forgoing and reallocating because the traditional income return on the Standard & Poor's 500 provides a stable, real return on equity principal that historically correlates with inflation and because 3% is understood by many as the historical real return on bonds. Moreover, the traditional return on the equity part of the portfolio can be understood as a return that is within the range of appropriate returns allocable to an income beneficiary. See Twentieth Century Fund, Task Force on College and University Endowment Policy, Funds for the Future 122 (1975) (This is, essentially, a monograph by J. Peter Williamson); James P. Garland, A Market-Yield Spending Rule for Endowments and Trusts, The Financial Analysts Journal, 50 (July/Aug 1989).

Example (5)--Having invested in assets generating no traditional income, the trustee chose to sell enough assets to generate a return for the income beneficiary. In reallocating, the trustee chose to consider as a factor a system used by some colleges and universities for determining current return on endowment in determining trust income. In doing so, the trustee took into account the different purposes, time horizons and tax exempt status of such organizations and the potential for additional gifts lacking in a private trust. T gave the income beneficiary an amount equal to 30% of 4.5 percent of the principal of the trust plus 70% of the amount paid in the prior year to the income beneficiary. This is a proper exercise of the power of reallocation because it takes into account beneficiary expectations and the inflation adjusted return on investments, and because it makes efficient and proper use of the expertise of professionals who closely study the annual return on investment assets. See Joel C. Dobris, Real Return, Modern Portfolio Theory and College, University and Foundation Decisions on Annual Spending From Endowments: A Visit to the World of Spending Rules 28 Real Prop., Prob., & Tr.J. 49 (1993).

Example (6)--Having invested in assets generating no traditional income, in reallocating the trustee chose to consider as a factor the National Association of College and University Business Officers (NACUBO) average endowment spending rate for college and university endowments for the previous year. In doing so, the trustee took into account the different purposes, time horizons and tax exempt status of such organizations and the potential for additional gifts lacking in a private trust. This is a proper exercise of the power of reallocation because, among other things, it makes efficient and proper use of the expertise of professionals who closely study the annual return on investment assets. See Twentieth Century Fund, Task Force on College and University Endowment Policy, Funds for the Future 122 (1975) (this is, in its essence, a monograph by J. Peter Williamson). *See also* Robert H. Jeffrey, The Folly of Market Timing, Harv. Bus. Rev., July-Aug 1984, at 102; Robert H. Jeffrey, A New Paradigm for Portfolio Risk, J. Portfolio Mgmt., Fall 1984, at 33.

Subsection (c). subsection (c) is designed to preserve the tax benefits sought by settlors in trusts created before and after the enactment of this Act.

Subsection (d). Subsection (d) deals with trust provisions forbidding trustees from making equitable adjustments. Ultimately, the effect of any provision in a document is a question of interpretation. Ordinarily, a clause that restrains the use of equitable adjustments is not to be read as disallowing the use of this equitable power of reallocation. Ordinarily, a clause that is in an instrument drafted before the promulgation of this Act is not to be construed as forbidding the use of this equitable power of reallocation. See generally, Joel C. Dobris, Limits on the Doctrine of Equitable Adjustment in Sophisticated Postmortem Tax Planning, 66 Iowa L. Rev. 273 (1981).

[ALTERNATIVE B]

[ARTICLE] 6

EQUITABLE ADJUSTMENTS

SECTION 601. TRUSTEE'S POWER TO REALLOCATE

(a) If after applying ~~the foregoing provisions~~ [Articles] 1 through 5 of this [Act], the trustee determines that to comply with § 102(a) it is necessary to reallocate between income and principal, the trustee ~~may~~ shall reallocate in whole or in part in such fair and reasonable manner and in such fair and reasonable proportions as the trustee determines is necessary to comply with § 102(a).

(b) In exercising the power of reallocation, a trustee shall consider, in addition to other relevant factors, such of the following factors, among others, as the trustee ~~deems~~ considers relevant to the trust or its beneficiaries:

(1) the nature, purpose and expected duration of the trust;

(2) the express intent of the settlor;

(3) the identity and circumstances of the beneficiaries;

(4) the actual and expected effect of economic conditions on principal and income and the possible effect of inflation and deflation;

(5) the expected tax consequences of a reallocation;

(6) the total return from investments;

(7) needs for liquidity, regularity of income, and preservation or appreciation of capital;

(8) the presence or absence of a power to invade principal or other dispositive provisions, that would reduce the importance of a reallocation, and the apparent reason for the presence or absence of such a provision; and

[ALTERNATIVE B]

(9) the assets held in the trust.

(c) The trustee may not make a reallocation pursuant to subsection (a) that would cause a loss, of all or part, of any federal or state gift tax exclusion, gift or estate tax marital deduction, income, gift or estate tax charitable deduction, or any inheritance tax deduction otherwise available to any estate or trust or to the settlor of a trust or a decedent. In addition, a trustee shall not exercise the power for the trustee's direct or indirect benefit, including the satisfaction or mitigation of any legal obligation of the trustee; however, a disinterested co-trustee may exercise the power.

(d) If a governing instrument limits the power~~s~~ of a trustee to make equitable adjustments, the instrument must not be construed to be contrary to this section unless it is clear from the instrument that it is intended to deny the trustee ~~access to~~ the power of reallocation.

Comment

Purpose and Scope of Provision. *This section~~, also~~ gives trustees the power to deal with extraordinary and unanticipated situations and to overrule unjust results under the standard provisions of the Act.*

Section 3B:19A-32 of the New Jersey, Statutes which was passed by the New Jersey legislature in 1991, allows the trustee faced with extraordinary and unanticipated situations to reallocate. That section takes meaning from section 45a-219 (d) of the Connecticut Statutes.

This section also alleviates the tension between modern rules for investing the assets held by a trustee and traditional ideas about what constitutes the return on a portfolio. As to modern trust investing, see the Uniform Prudent Investor Act (1994).

[ALTERNATIVE B]

This section allows the trustee to undertake the best, the most prudent and totally most productive investment of all the trust assets without concern about whether the investments chosen have the effect of impartially allocating the investment return between the income and principal beneficiaries. Both income and principal beneficiaries are entitled to proper return, and the allocation of that return should not have to be a function of the particular assets chosen by the trustee. This section also allows the trustee to follow the well understood traditional system of allocating receipts and expenditures in many situations.

This section is not limited to the trustee who is a modern portfolio theory investor.

If the trustee invests all the assets of a trust, taken as a portfolio, in a way that will have an initially ~~unsuitable~~ unfair effect without a reallocation of return this section allows the trustee to reallocate. The power to reallocate receipts spares the trustee from having to choose second best investments. This power also allows the trustee to deal impartially and effectively with the effect of inflation and deflation on investment returns.

The change -- giving a trustee the power to reallocate portfolio returns between income and principal -- is less dramatic than it might first seem to be. The prior Principal and Income Acts inferentially allowed a range of possible returns for successive beneficiaries via asset choice and asset allocation. There were a number of legally acceptable, impartial portfolios for any given trust that would produce a variety of income and principal outcomes. Consider a hypothetical world in which financial assets invested at a particular level of risk could earn a total return of 8%. The trustee could prudently choose within a universe of portfolios -- for example, a portfolio that provided 5% income and 3% growth or 5.5% income and 2.5% growth or 4.5% income and 3.5% growth. So, the trustee always had the power to affect the return to beneficiaries.

Operating under this section, if the trustee concludes that the outcome of a conventional allocation between principal and income would be ~~unsuitable~~ unfair, then the trustee ~~should~~ must reallocate to achieve a ~~suitable~~ fair and reasonable result.

Taxes. It is expected that reallocated income will be the income of the trust under the law of any state adopting the Act. It is the intent of the drafters that any capital gains realized to fund a reallocation payment to the income beneficiary shall be allocated to the income beneficiary.

It is hoped the marital deduction will be available under this section of the Act.

Fiduciary duty. This power is subject to a fair and reasonable conduct standard. ~~an abuse of discretion standard. Reasonable trustee action is not subject to judicial review except to prevent an abuse of discretion. See Restatement (Second) of Trusts § 187 (1959). See also id §§ 183, 232, 233, comment p (1959).~~

There is an intrinsic tension in trust law between granting trustees broad powers that facilitate flexible and efficient trust administration, and protecting trust beneficiaries from the misuse of such powers. A broad trustee's power, such as those found in most lawyer-drafted instruments and exemplified in the Uniform Trustees' Powers Act, permits the trustee to act vigorously and expeditiously to maximize the interest of the beneficiaries in a variety of transactions and administrative settings. Trust law relies upon the duties of loyalty, impartiality and prudent administration, and upon procedural safeguards such as periodic accounting and the availability of judicial oversight, to prevent the misuse of such powers. Reallocation, which is a species of trustee power, raises the same tension. If the trustee reallocates effectively, the beneficiaries obtain the advantage of the underlying investment and the allocation. But if the trustee reallocates ineffectively the reallocation can do harm.

This section is designed to strike the appropriate balance not only between the advantages and the hazards of reallocation, but also between the advantages and hazards of reworking a known investment/allocation system.

This section is subject to the injunctions in Section 102 of this Act including the one that the trustee "shall be fair and reasonable to all of the beneficiaries unless the governing instrument clearly manifests an intention that the fiduciary must or may favor one or more beneficiaries." This section is also subject to the limitations on fiduciary liability in Section 103.

Default rule. This section is a default rule of trust law. A settlor can expressly set aside this rule, just as a settlor can establish a noncharitable unitrust, instead of a traditional trust, to avoid some of the problems that arise when a trustee invests in a modern fashion within a traditional trust.

Examples. The following examples demonstrate the function of the reallocation approach in the context of modern investing:

Example (1)--T is the trustee of a trust that provides income for a surviving spouse for life, remainder to another. The trust portfolio is 60% invested in a portfolio of stocks or mutual fund that seeks to replicate the performance of the Standard & Poor's 500 and 40% invested in a bond portfolio or mutual fund that seeks to replicate the performance of the U.S. Bond Market as a whole. Trustee paid the traditional income attributable to both funds to the income beneficiary. The trustee is justified in forgoing use of the reallocation power because, historically, the traditional income return on the Standard & Poor's 500 provides a stable, real return on equity principal that is strongly correlated to the Consumer Price Index and because a surviving spouse, can properly be understood as a primary object of the settlor's bounty. Moreover, the traditional return on both parts of the portfolio can be understood as a return that is within the range of appropriate returns allocable to an income beneficiary.

Example (2)--Having invested the entire trust in a stock portfolio designed to replicate the performance of the Standard & Poor's 500 or in a no-load, low-transaction cost mutual fund that passively invests in the stocks in the Standard & Poor's 500 average, the trustee allocates in a traditional fashion under the general terms of the act. The trustee's objective was to keep the income stream smooth and stable, even with inflation, and to preserve the power of the portfolio to produce such a stream of income over an extended period of time. The trustee expected that there would continue to be a correlation between the dividends paid by the S & P 500 and the Consumer Price Index. The trustee is justified in forgoing use of the reallocation power because the traditional income return on the Standard

& Poor's 500 meets the stated goals. Moreover, the traditional return on the portfolio can be understood as a return that is within the range of appropriate returns allocable to an income beneficiary. See Twentieth Century Fund, Task Force on College and University Endowment Policy, Funds for the Future 122 (1975) (this is, in its essence, a monograph by J. Peter Williamson); James P. Garland, A Market-Yield Spending Rule for Endowments and Trusts, The Financial Analysts Journal, 50, 53 (July/Aug 1989). See also Robert H. Jeffrey, The Folly of Market Timing, Harv. Bus. Rev., July-Aug 1984, at 102; Robert H. Jeffrey, A New Paradigm for Portfolio Risk, J. Portfolio Mgmt., Fall 1984, at 33.

Example (3)--Having invested in a portfolio that was 60% invested in stocks or a mutual fund that seeks to replicate the performance of the Standard & Poor's 500 and 40% invested in a bond portfolio or mutual fund that seeks to replicate the performance of the U.S. Bond Market as a whole, the trustee paid the traditional income attributable to the S&P 500 fund to the income beneficiary, but capped the traditional income attributable to the bonds, or bond fund, by reference to the Consumer Price Index, adding the balance of the income earned by the bond fund to principal in order to preserve the real value of the principal. The trustee's objective was to keep the income stream smooth and stable, even with inflation, and to preserve the power of the portfolio to produce such a stream of income over an extended period of time. The trustee is justified in forgoing the power of reallocation because the traditional income return on the Standard & Poor's 500 provides a stable, real return on equity principal that strongly correlates with the Consumer Price Index. The trustee is justified in reallocating the traditional income from the bonds, or bond fund, because Consumer Price Index adjustments in payments are understood by many to be an appropriate way for providing for a real return on bonds. See James P. Garland, A Market-Yield Spending Rule for Endowments and Trusts, The Financial Analysts Journal, 50 (July/Aug 1989).

Example (4)--Having invested in a portfolio that was 60% invested in stocks or a mutual fund that seeks to replicate the performance of the Standard & Poor's 500 and 40% invested in a bond portfolio or mutual fund that seeks to replicate the performance of the U.S. Bond Market as a whole, the trustee paid the traditional income attributable to the S&P 500 stocks, or fund, to the income beneficiary, but capped the traditional income attributable to the bonds, or bond fund, at 3%, adding the balance of the income earned by the bonds, or bond fund, to principal in order to preserve the real value of the principal. The trustee's objective was to keep the income stream smooth and stable, even with inflation, and to preserve the power of the portfolio to produce such a stream of income over an extended period of time. This was done during a period when there was a strong correlation between the dividends paid by the S & P 500 and the Consumer Price Index. The trustee is justified in forgoing and reallocating because the traditional income return on the Standard & Poor's 500 provides a stable, real return on equity principal that historically correlates with inflation and because 3% is understood by many as the historical real return on bonds. Moreover, the traditional return on the equity part of the portfolio can be understood as a return that is within the range of appropriate returns allocable to an income beneficiary. See Twentieth Century Fund, Task Force on College and University Endowment Policy, Funds for the Future 122 (1975) (This is, essentially, a monograph by J. Peter Williamson); James P. Garland, A Market-Yield Spending Rule for Endowments and Trusts, The Financial Analysts Journal, 50 (July/Aug 1989).

[ALTERNATIVE B]

Example (5)--Having invested in assets generating no traditional income, the trustee chose to sell enough assets to generate a return for the income beneficiary. In reallocating, the trustee chose to consider as a factor a system used by some colleges and universities for determining current return on endowment in determining trust income. In doing so, the trustee took into account the different purposes, time horizons and tax exempt status of such organizations and the potential for additional gifts lacking in a private trust. T gave the income beneficiary an amount equal to 30% of 4.5 percent of the principal of the trust plus 70% of the amount paid in the prior year to the income beneficiary. This is a proper exercise of the power of reallocation because it takes into account beneficiary expectations and the inflation adjusted return on investments, and because it makes efficient and proper use of the expertise of professionals who closely study the annual return on investment assets. See Joel C. Dobris, Real Return, Modern Portfolio Theory and College, University and Foundation Decisions on Annual Spending From Endowments: A Visit to the World of Spending Rules 28 Real Prop., Prob., & Tr.J. 49 (1993).

Example (6)--Having invested in assets generating no traditional income, in reallocating the trustee chose to consider as a factor the National Association of College and University Business Officers (NACUBO) average endowment spending rate for college and university endowments for the previous year. In doing so, the trustee took into account the different purposes, time horizons and tax exempt status of such organizations and the potential for additional gifts lacking in a private trust. This is a proper exercise of the power of reallocation because, among other things, it makes efficient and proper use of the expertise of professionals who closely study the annual return on investment assets. See Twentieth Century Fund, Task Force on College and University Endowment Policy, Funds for the Future 122 (1975) (this is, in its essence, a monograph by J. Peter Williamson). *See also* Robert H. Jeffrey, The Folly of Market Timing, Harv. Bus. Rev., July-Aug 1984, at 102; Robert H. Jeffrey, A New Paradigm for Portfolio Risk, J. Portfolio Mgmt., Fall 1984, at 33.

Subsection (c). Subsection (c) is designed to preserve the tax benefits sought by settlors in trusts created before and after the enactment of this Act.

Subsection (d). Subsection (d) deals with trust provisions forbidding trustees from making equitable adjustments. Ultimately, the effect of any provision in a document is a question of interpretation. Ordinarily, a clause that restrains the use of equitable adjustments is not to be read as disallowing the use of this equitable power of reallocation. Ordinarily, a clause that is in an instrument drafted before the promulgation of this Act is not to be construed as forbidding the use of this equitable power of reallocation. See generally, Joel C. Dobris, Limits on the Doctrine of Equitable Adjustment in Sophisticated Postmortem Tax Planning, 66 Iowa L. Rev. 273 (1981).

[ALTERNATIVE C]

[ARTICLE] 6

EQUITABLE ADJUSTMENTS

SECTION 601. TRUSTEE'S POWER TO REALLOCATE

(a) ~~If after~~ After applying ~~the foregoing provisions~~ [Articles] 1 through 5 of this [Act], the trustee shall determine if the trustee has complied with § 102(a) of this [Act]. ~~the trustee determines that to comply with § 102(a) it is necessary to reallocate between income and principal, the trustee may reallocate in whole or in part in such manner and in such proportions as the trustee determines~~. In making that determination the trustee ~~(b) In exercising the power of reallocation, a trustee~~ shall consider, in addition to other relevant factors, such of the following factors, among others, as the trustee ~~deems~~ considers relevant to the trust or its beneficiaries:

(1) the nature, purpose and expected duration of the trust;

(2) the express intent of the settlor;

(3) the identity and circumstances of the beneficiaries;

(4) the actual and expected effect of economic conditions on principal and income and the possible effect of inflation and deflation;

(5) the expected tax consequences of a reallocation;

(6) the total return from investments;

(7) needs for liquidity, regularity of income, and preservation or appreciation of capital;

(8) the presence or absence of a power to invade principal or other dispositive provisions, that would reduce the importance of a reallocation, and the apparent

reason for the presence or absence of such a provision; and

(9) the assets held in the trust.

(b) *If after applying* section (a) of this section the trustee determines that to comply with § 102(a) it is necessary to reallocate between income and principal, the trustee ~~may~~ shall reallocate in whole or in part in such fair and reasonable manner and in such fair and reasonable proportions as the trustee determines is necessary to comply with § 102(a).

(c) The trustee may not make a reallocation pursuant to subsection (a) that would cause a loss, of all or part, of any federal or state gift tax exclusion, gift or estate tax marital deduction, income, gift or estate tax charitable deduction, or any inheritance tax deduction otherwise available to any estate or trust or to the settlor of a trust or a decedent. In addition, a trustee shall not exercise the power for the trustee's direct or indirect benefit, including the satisfaction or mitigation of any legal obligation of the trustee; however, a disinterested co-trustee may exercise the power.

(d) If a governing instrument limits the power~~s~~ of a trustee to make equitable adjustments, the instrument must not be construed to be contrary to this section unless it is clear from the instrument that it is intended to deny the trustee ~~access to~~ the power of reallocation.

Comment

Purpose and Scope of Provision. *This section~~, also~~ gives trustees the power to deal* *with extraordinary and unanticipated situations and to overrule unjust results under the standard provisions of the Act.*

Section 3B:19A-32 of the New Jersey, Statutes which was passed by the New Jersey legislature in 1991, allows the trustee faced with extraordinary and unanticipated situations to reallocate. That section takes meaning from section 45a-219 (d) of the Connecticut Statutes.

This section also alleviates the tension between modern rules for investing the assets held by a trustee and traditional ideas about what constitutes the return on a portfolio. As to modern trust investing, see the Uniform Prudent Investor Act (1994).

This section allows the trustee to undertake the best, the most prudent and totally most productive investment of all the trust assets without concern about whether the investments chosen have the effect of impartially allocating the investment return between the income and principal beneficiaries. Both income and principal beneficiaries are entitled to proper return, and the allocation of that return should not have to be a function of the particular assets chosen by the trustee. This section also allows the trustee to follow the well understood traditional system of allocating receipts and expenditures in many situations.

This section is not limited to the trustee who is a modern portfolio theory investor.

If the trustee invests all the assets of a trust, taken as a portfolio, in a way that will have an initially ~~unsuitable~~ unfair effect without a reallocation of return this section allows the trustee to reallocate. The power to reallocate receipts spares the trustee from having to choose second best investments. This power also allows the trustee to deal impartially and effectively with the effect of inflation and deflation on investment returns.

The change -- giving a trustee the power to reallocate portfolio returns between income and principal -- is less dramatic than it might first seem to be. The prior Principal and Income Acts inferentially allowed a range of possible returns for successive beneficiaries via asset choice and asset allocation. There were a number of legally acceptable, impartial portfolios for any given trust that would produce a variety of income and principal outcomes. Consider a hypothetical world in which financial assets invested at a particular level of risk could earn a total return of 8%. The trustee could prudently choose within a universe of portfolios -- for example, a portfolio that provided 5% income and 3% growth or 5.5% income and 2.5% growth or 4.5% income and 3.5% growth. So, the trustee always had the power to affect the return to beneficiaries.

Operating under this section, if the trustee concludes that the outcome of a conventional allocation between principal and income would be ~~unsuitable~~ unfair, then the trustee ~~should~~ must reallocate to achieve a ~~suitable~~ fair and reasonable result.

Taxes. It is expected that reallocated income will be the income of the trust under the law of any state adopting the Act. It is the intent of the drafters that any capital gains realized to fund a reallocation payment to the income beneficiary shall be allocated to the income beneficiary.

[ALTERNATIVE C]

It is hoped the marital deduction will be available under this section of the Act.

Fiduciary duty. This power is subject to a fair and reasonable conduct standard. ~~an abuse of discretion standard. Reasonable trustee action is not subject to judicial review except to prevent an abuse of discretion. See Restatement (Second) of Trusts § 187 (1959). See also id §§ 183, 232, 233, comment p (1959).~~

There is an intrinsic tension in trust law between granting trustees broad powers that facilitate flexible and efficient trust administration, and protecting trust beneficiaries from the misuse of such powers. A broad trustee's power, such as those found in most lawyer-drafted instruments and exemplified in the Uniform Trustees' Powers Act, permits the trustee to act vigorously and expeditiously to maximize the interest of the beneficiaries in a variety of transactions and administrative settings. Trust law relies upon the duties of loyalty, impartiality and prudent administration, and upon procedural safeguards such as periodic accounting and the availability of judicial oversight, to prevent the misuse of such powers. Reallocation, which is a species of trustee power, raises the same tension. If the trustee reallocates effectively, the beneficiaries obtain the advantage of the underlying investment and the allocation. But if the trustee reallocates ineffectively the reallocation can do harm.

This section is designed to strike the appropriate balance not only between the advantages and the hazards of reallocation, but also between the advantages and hazards of reworking a known investment/allocation system.

This section is subject to the injunctions in Section 102 of this Act including the one that the trustee "shall be fair and reasonable to all of the beneficiaries unless the governing instrument clearly manifests an intention that the fiduciary must or may favor one or more beneficiaries." This section is also subject to the limitations on fiduciary liability in Section 103.

Default rule. This section is a default rule of trust law. A settlor can expressly set aside this rule, just as a settlor can establish a noncharitable unitrust, instead of a traditional trust, to avoid some of the problems that arise when a trustee invests in a modern fashion within a traditional trust.

Examples. The following examples demonstrate the function of the reallocation approach in the context of modern investing:

Example (1)--T is the trustee of a trust that provides income for a surviving spouse for life, remainder to another. The trust portfolio is 60% invested in a portfolio of stocks or mutual fund that seeks to replicate the performance of the Standard & Poor's 500 and 40% invested in a bond portfolio or mutual fund that seeks to replicate the performance of the U.S. Bond Market as a whole. Trustee paid the traditional income attributable to both funds to the income beneficiary. The trustee is justified in forgoing use of the reallocation power because, historically, the traditional income return on the Standard & Poor's 500 provides a stable, real return on equity principal that is strongly correlated to the Consumer Price Index and because a surviving spouse, can properly be understood as a primary object of the settlor's bounty.

[ALTERNATIVE C]

Moreover, the traditional return on both parts of the portfolio can be understood as a return that is within the range of appropriate returns allocable to an income beneficiary.

Example (2)--Having invested the entire trust in a stock portfolio designed to replicate the performance of the Standard & Poor's 500 or in a no-load, low-transaction cost mutual fund that passively invests in the stocks in the Standard & Poor's 500 average, the trustee allocates in a traditional fashion under the general terms of the act. The trustee's objective was to keep the income stream smooth and stable, even with inflation, and to preserve the power of the portfolio to produce such a stream of income over an extended period of time. The trustee expected that there would continue to be a correlation between the dividends paid by the S & P 500 and the Consumer Price Index. The trustee is justified in forgoing use of the reallocation power because the traditional income return on the Standard & Poor's 500 meets the stated goals. Moreover, the traditional return on the portfolio can be understood as a return that is within the range of appropriate returns allocable to an income beneficiary. See Twentieth Century Fund, Task Force on College and University Endowment Policy, Funds for the Future 122 (1975) (this is, in its essence, a monograph by J. Peter Williamson); James P. Garland, A Market-Yield Spending Rule for Endowments and Trusts, The Financial Analysts Journal, 50, 53 (July/Aug 1989). See also Robert H. Jeffrey, The Folly of Market Timing, Harv. Bus. Rev., July-Aug 1984, at 102; Robert H. Jeffrey, A New Paradigm for Portfolio Risk, J. Portfolio Mgmt., Fall 1984, at 33.

Example (3)--Having invested in a portfolio that was 60% invested in stocks or a mutual fund that seeks to replicate the performance of the Standard & Poor's 500 and 40% invested in a bond portfolio or mutual fund that seeks to replicate the performance of the U.S. Bond Market as a whole, the trustee paid the traditional income attributable to the S&P 500 fund to the income beneficiary, but capped the traditional income attributable to the bonds, or bond fund, by reference to the Consumer Price Index, adding the balance of the income earned by the bond fund to principal in order to preserve the real value of the principal. The trustee's objective was to keep the income stream smooth and stable, even with inflation, and to preserve the power of the portfolio to produce such a stream of income over an extended period of time. The trustee is justified in forgoing the power of reallocation because the traditional income return on the Standard & Poor's 500 provides a stable, real return on equity principal that strongly correlates with the Consumer Price Index. The trustee is justified in reallocating the traditional income from the bonds, or bond fund, because Consumer Price Index adjustments in payments are understood by many to be an appropriate way for providing for a real return on bonds. See James P. Garland, A Market-Yield Spending Rule for Endowments and Trusts, The Financial Analysts Journal, 50 (July/Aug 1989).

Example (4)--Having invested in a portfolio that was 60% invested in stocks or a mutual fund that seeks to replicate the performance of the Standard & Poor's 500 and 40% invested in a bond portfolio or mutual fund that seeks to replicate the performance of the U.S. Bond Market as a whole, the trustee paid the traditional income attributable to the S&P 500 stocks, or fund, to the income beneficiary, but capped the traditional income attributable to the bonds, or bond fund, at 3%, adding the balance of the income earned by the bonds, or bond fund, to principal in order to preserve the real value of the principal. The trustee's objective was to keep the income stream smooth and stable, even with inflation, and to preserve the power of the portfolio to produce such a stream of income over an extended period of time. This was done during a period when there was a strong correlation between the dividends paid by the S & P 500 and the Consumer Price Index. The trustee is justified in forgoing and reallocating because the traditional income return on the Standard & Poor's 500 provides a stable, real return on equity principal that historically correlates with inflation and because 3% is understood by many as the historical real return on bonds. Moreover, the traditional return on the equity part of the portfolio can be understood as a return that is within the range of appropriate returns allocable to an income beneficiary. See Twentieth Century Fund, Task Force on College and University Endowment Policy, Funds for the Future 122 (1975) (This is, essentially, a monograph by J. Peter Williamson); James P. Garland, A Market-Yield Spending Rule for Endowments and Trusts, The Financial Analysts Journal, 50 (July/Aug 1989).

Example (5)--Having invested in assets generating no traditional income, the trustee chose to sell enough assets to generate a return for the income beneficiary. In reallocating, the trustee chose to consider as a factor a system used by some colleges and universities for determining current return on endowment in determining trust income. In doing so, the trustee took into account the different purposes, time horizons and tax exempt status of such organizations and the potential for additional gifts lacking in a private trust. T gave the income beneficiary an amount equal to 30% of 4.5 percent of the principal of the trust plus 70% of the amount paid in the prior year to the income beneficiary. This is a proper exercise of the power of reallocation because it takes into account beneficiary expectations and the inflation adjusted return on investments, and because it makes efficient and proper use of the expertise of professionals who closely study the annual return on investment assets. See Joel C. Dobris, Real Return, Modern Portfolio Theory and College, University and Foundation Decisions on Annual Spending From Endowments: A Visit to the World of Spending Rules 28 Real Prop., Prob., & Tr.J. 49 (1993).

Example (6)--Having invested in assets generating no traditional income, in reallocating the trustee chose to consider as a factor the National Association of College and University Business Officers (NACUBO) average endowment spending rate for college and university endowments for the previous year. In doing so, the trustee took into account the different purposes, time horizons and tax exempt status of such organizations and the potential for additional gifts lacking in a private trust. This is a proper exercise of the power of reallocation because, among other things, it makes efficient and proper use of the expertise of professionals who closely study the annual return on investment assets. See Twentieth Century Fund, Task Force on College and University Endowment Policy, Funds for the Future 122 (1975) (this is, in its essence, a monograph by J. Peter Williamson). *See also* Robert H. Jeffrey, The Folly of Market Timing, Harv. Bus. Rev., July-Aug 1984, at 102; Robert H. Jeffrey, A New Paradigm for Portfolio Risk, J. Portfolio Mgmt., Fall 1984, at 33.

Subsection (c). subsection (c) is designed to preserve the tax benefits sought by settlors in trusts created before and after the enactment of this Act.

Subsection (d). Subsection (d) deals with trust provisions forbidding trustees from making equitable adjustments. Ultimately, the effect of any provision in a document is a question of interpretation. Ordinarily, a clause that restrains the use of equitable adjustments is not to be read as disallowing the use of this equitable power of reallocation. Ordinarily, a clause that is

[ALTERNATIVE C]

in an instrument drafted before the promulgation of this Act is not to be construed as forbidding the use of this equitable power of reallocation. See generally, Joel C. Dobris, Limits on the Doctrine of Equitable Adjustment in Sophisticated Postmortem Tax Planning, 66 Iowa L. Rev. 273 (1981).