THE "FIXED-INCOME," "ANNUITY" AND "MODERNIZED" TYPES OF TRUST

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Discussions of the problem of the investment of trust funds are usually, and quite naturally, premised on the assumption that the trusts giving rise to the problem are of the conventional type. However, recent years have witnessed a significant departure from the customary trust in the development of the "Fixed-Income," "Annuity," and "Modernized" types of trust. Since resort to any of these trust forms presents for the trustee an investment problem quite different from that confronting him under a trust of the usual type, a comprehensive treatment of the trust investment problem calls for a consideration of these newer trust forms in relation to that problem.

The "Fixed-Income," "Annuity" and "Modernized" types of trust differ slightly from each other. That difference will be explained near the end of this paper. The three of them join, however, in a common dissimilarity to the conventional trust in that the latter provides that *earned* income *only* shall go to the life tenant, the entire corpus supposedly to be conserved for the remaindermen. The "Fixed-Income," "Annuity" and "Modernized" types provide for stipulated payments to the life tenant regardless of what income may actually be *earned*.

In treating the subject of the "Fixed-Income," "Annuity" and "Modernized" types of trust, the author assumes that this article may be read by both trustees and trustors, or at least by the latter's legal representatives. It shall be his aim, therefore, to discuss this type of trust from the point of view of its advantages both to trustees and to trust beneficiaries. The plan seems to harbor no *dis*advantage for either.

Whence came the *conventional*, "*earned*-income-*only* to the life tenant" trust form, and how it could possibly have achieved such almost universal usage, it is apparently futile to speculate. Probably the first trusts were employed by wealthy testators whose estates were of adequate size to warrant this conventional form—that is, their earnings, even at low rates of interest, were ample to support the life tenant on the scale to which she was accustomed. When, however, this conventional form is employed for estates whose size is so small that earnings of 6%, 5% or even 4%

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are necessary to maintain the life tenant at her customary scale of living, then indeed does the conventional trust fail. It not only fails to achieve the purpose of the testator with respect *to both life tenant and remaindermen,* but it also involves the trustee in problems of investment management which are practically impossible of solution. It is probably safe to say that much of the unsatisfactory investment management of trust companies, of late years, has been due in no small measure to this conventional, "*earned*-income-*only* to the life tenant" type of trust instrument under which they have been operating.

Let us see how this disservice to beneficiaries and this intensification of the difficulties of investment management to trustees are brought about by the conventional form of trust.

There are *occasional* instances of testators whose chief interest and regard, for one reason or another, center in the remainderman or—men, and whose concern for the life tenant, usually the wife, is secondary. But these instances are comparatively so rare that for the purpose of this discussion it may safely be assumed that the prime concern of the average testator is for his wife. He wants her, should he predecease her, to live out her days with the same degree of comfort she has enjoyed prior to his death.

Mr. Smith is a man who has accumulated several hundred thousand dollars. He and his wife have lived modestly and comfortably on $12,000 per year. During the period he has been investing money (let us say from 1910 to 1930) he has been able to secure an average return of 5%. He has allowed for all liabilities including death duties and finds that, should he die, his net estate will equal or slightly exceed $200,000. He believes that his wife's living expenses, without him, should be not more than $10,000, which would be 5% of $200,000. He wants to avoid the possibility of duplicate estate taxes when his wife dies and he therefore incorporates in his will the conventional trust, providing that his wife shall receive the *earned* income (presumably 5%) as long as she lives, the corpus to pass, at her death, to his two children. Such an arrangement appears sound in every respect to Mr. Smith and he dies in 1930, happy in the thought that his wife will be supported in comfort through her remaining years, and that his children will each receive $100,000 when his wife passes on.

But Mr. Smith, never having died before, has failed to contemplate several eventualities, and those with whom he has advised—his lawyer and his trust company—have failed to warn him. Interest rates begin to decline. This economic phenomenon might well have resulted from natural causes. That the government took a hand in "easing money" made no difference. The result was the same. Within a few years it developed that the same high grade of security could not be purchased at a yield of 5%. Bonds and mortgages which formerly yielded 5% were called and reissued at 4%, or 3½%, or even 3.

Now we come to the breakdown of the conventional, "*earned*-income-*only* to the life tenant" type of trust. Let us mark its triple failure: (1) in its intensification of

difficulties for the trust company, (2) in its failure to provide adequate income for the life tenant, and (3) in its failure to conserve the capital of the remaindermen.

The trust company Mr. Smith had selected was soon faced with the question of whether it should adhere to high-grade bonds, thus decreasing Mrs. Smith's income, or invest in lower-grade securities in which a greater degree of risk would have to be assumed. It is not at all difficult to imagine the tone of the conference at which the decision was made. Visualize Mr. Brown, Mr. Black and Mr. White.

Mr. Brown: "I have called this meeting for the purpose of making a decision on the Smith trust. We must either ask Mrs. Smith to accept a smaller income or we must begin to invest in lower-grade securities. Which shall it be?"

Mr. Black: "I hate to do either, but certainly it must be one or the other. What do you say, Mr. White?"

Mr. White: "Well, I knew Harold Smith better probably than either of you. I am sure he placed his trust with this bank because he felt we would have a personal interest in his wife. I know that Harold, first of all wanted his wife taken care of—wanted her to continue to live on the same scale to which she has been accustomed. I hate to cut down on the grade of securities just as much as you two do, but I think we had better try to keep Helen's income at $10,000. I know Harold would want us to do it that way if he were here. Of course, we must continue to invest in 'legals,' the trust doesn't permit us to invest outside, but there are a number of issues that are yielding five and some of the real estate bonds and mortgages yield six. Do the best you can, Walter, but keep her income up by all means. These low rates won't last forever and we can switch back into the higher grades when interest rates stiffen a little."

And so it was decided to depart from the high-grade issues—to maintain a 5% income for Mrs. Smith.

But interest rates did not "stiffen a little." They kept getting lower and lower, and, as is always the case when an investor seeks 5% in a 3% market, some of those 5% and 6% bonds and mortgages defaulted, while others declined drastically in prospect of default. What had happened to the "Smith" trust is precisely what has happened to thousands of other trusts throughout the country. The trust company and the lawyer knew that Mr. Smith's chief concern, when he set up the trust, was for his wife, yet they advised or permitted him to employ a trust instrument which made it practically impossible for the trust company to carry out his wishes. Results: (1) The trust company had a much more difficult task than it might have had, and eventually suffered considerable embarrassment because of the ill success of the management; (2) Mrs. Smith's income eventually had to be reduced; (3) the corpus of the trust, which was to have been conserved for the remaindermen, was sadly depleted.

Now let us see how the "Fixed-Income," "Annuity" and "Modernized" types of trust could have avoided this triple failure. That type *does not limit the life tenant's income to what may be earned.* It provides that she shall draw a stipulated amount

per year, regardless of *earnings*. Had Mr. Smith's trust been of that type, the situation would have been changed as follows:

1. The trust company personnel would have had a much simpler investment problem. They could have invested in high-grade bonds and mortgages yielding 3% instead of looking for 5%, and they probably would have avoided the embarrassment of a poor management record, not to mention the possibility of surcharge. (I say "probably" because the problem of successful investment management is not so simple that mistakes are not possible, even in issues yielding 3%.)
2. Mrs. Smith would have received her $10,000 per year, just as her husband had planned, instead of having her income reduced, perhaps drastically.
3. The corpus of the trust would have been reduced by 2% or less each year; but let those who would worry about a reduction of 2% per annum compare that figure with the losses sustained in a program devoted to securing a 5% return in a 3% market. It must be borne in mind too that Mr. Smith, like most testators, regardless of the amount to be received by his children, wanted his wife taken care of first. "I know Harold would want us to do it that way if he were here."

The Customary "Invasion of Principal" Clause Inadequate

Why any officer of a trust company, of all people, should shun the "Fixed-Income," "Annuity" or "Modernized" type of trust is beyond comprehension, but for some reason many of them do, and their usual response to the suggestion is that their customary clause, providing that principal may be invaded for the support and comfort of the life tenant, is adequate to take care of any situation which may arise.

The customary "invasion of principal" clause would seem to be entirely *in*adequate for this purpose for three reasons. In the first place, no testator who has a proper respect for his wife will want to place her in a position where she will have to argue with some junior (or senior, for that matter) trust officer as to whether she may draw $600 this month (and the next, and the next) or $800, or some other figure. But argue she will have to, it seems certain, under the customary "invasion of principal" clause, where the wisdom of the withdrawal must be approved by the trustee, and sometimes by the court. She will have to argue, and argue very convincingly, for the trustee cannot permit himself to be swayed solely by *her* needs. Under the conventional trust the trustees must also bear in mind the interests of the remaindermen. If they are too free in their invasion of principal for the life tenant, how can they be assured that one of the remaindermen will not take it into his head ten or twenty years from now to surcharge the trust company? Trustees are very careful about matters of this kind. They have to be, for they have had some bitter experiences in the actions of remaindermen, particularly after "mother" has passed away and the trust is ready for distribution. Furthermore, the very conditions which require "invasion of principal" are likely to necessitate the sale of securities at abnormally low prices. Clearly the customary "invasion of principal" clause will prove a poor substitute for the "Fixed-Income," "Annuity" or "Modernized" trust plan.

Administrative Detail Less Involved

There is one type of administrative detail in the conventional form of trust (among others of similar nature) which has caused no little trouble to trust institutions of late years. In the case of a stock dividend, shall it be credited to income or to principal? Shall the wife get it, or the children? And the distribution of the salvage from defaulted mortgages on unproductive real estate? How shall that be divided between life tenant and the remaindermen? Indicative of the concern of fiduciaries over this problem is a recent subtitle of a magazine article on this subject which reads:

"Solving One of the Most Complicated and *Expensive* Problems of the Fiduciary, with Justice to Beneficiaries"

Administrative problems of this nature exist to a much less degree when the "Fixed-Income," "Annuity" or "Modernized" type of trust is employed—another reason, one would think, not only for trust companies' acceptance, but for their preference for this type of trust. Furthermore the risk of surcharge for errors is reduced.

Provision for Excess Earnings

If, for example, in the "Smith" case, actual earnings of the trust during a given year exceed $10,000, what shall be done with the excess? In some states, including New York, it is illegal for the trustee to accumulate income, except under conditions which would not be helpful, under circumstances such as these, or those that would usually be encountered. Accordingly, the trust should, of course, include a provision that in the event of such excess earnings, the excess must be paid to the life tenant or to some other designated beneficiary.

Income Taxes

"What about income taxes," the writer has been asked, "under the 'Fixed-Income,' 'Annuity' or 'Modernized' type of trust?"

There would seem to be nothing here to worry about. On the other hand, there might be a distinct advantage. Under present Internal Revenue Bureau rulings and court decisions, I believe I am correctly informed that income earned by a trust of the "Fixed-Income," "Annuity" or "Modernized" type (depending upon the terms of the trust) is taxable to the trustee, the tax, of course, being paid from the corpus of the trust.[1] Thus, in the "Smith" case, even though Mrs. Smith received $10,000 per year from the trust, income tax would be paid by the trustee only on the *earned* income, let us say $6,000. But suppose that Mrs. Smith has *other* income, perhaps

[1] The leading cases are Burnet v. Whitehouse, 283 U. S. 148 (1931), and Helvering v. Butterworth, 290 U. S. 365 (1933). The subject is discussed in Brown, *Some Unsolved Tax Problems of Fiduciaries* (Feb. 1938) 66 TRUST COMPANIES 200. As the title of that article indicates, not all aspects of the subject have been definitely settled. Incidentally, where the trust provides merely for the invasion of principal at the discretion of the trustee, the Board of Tax Appeals has ruled that the tax is imposed upon the beneficiary rather than upon the trustee. *Id.* at 27.

$9,000 from another source. Under the conventional "*earned*-income-*only* to the life tenant" type of trust, *she* would pay the income tax—and she would have to pay on the basis of *a total income of $15,000.* Under the "Fixed-Income," "Annuity" or "Modernized" type of trust, she would pay her tax on a total income of $9,000, and the trustee would pay on the basis of a total income of $6,000—a considerable saving because of the lower brackets.

The "Fixed-Income," "Annuity" and "Modernized" Types of Trust Differentiated

The three separate terms named above are currently used to designate that type of trust which pays the life tenant a stipulated sum per annum, regardless of the income which may be actually earned, but as hereinbefore mentioned, there are slight differences between the three. With the goal of becoming better acquainted with this general type of trust, and of comparing special features and objectives, let us examine each of the three conceptions in some detail.

A. The "Fixed-Income" Type of Trust

As the designation implies, this type of trust is designed to pay the life tenant a "fixed income"—a certain number of dollars per year, regardless of the actual earnings of the trust, which might, as far as the designation implies, be either less or greater than the amount to be paid the life beneficiary. The inference, in contrast to the term "annuity," would seem to be that there is no question but that the corpus of the trust is adequate in size to stand any measure of drain to which it might be subjected, due either to the excess of withdrawals over earnings, or to the protracted longevity of the life tenant, or both.

May we not say, then, that the term "Fixed-Income Trust" envisages a trust of a size so ample that earnings—while they may vary from year to year (or from quinquennium to quinquennium, for that matter)—will, over the long term, prove approximately ample to cover the stipulated withdrawals?

B. The "Annuity" Type of Trust

The term "Annuity" suggests quite a different situation. An "annuity," in the commonly accepted sense of the term, actually implies a reduction of principal year by year. The term implies, moreover, that the principal, reduced gradually, will last just long enough to pay the annuitant his annual stipend until death.

The life insurance company knows, from its mortality table, that the *average* man of sixty will live fourteen and one-tenth years, but John Doe may live to be eighty while Richard Roe dies at sixty-two. It is impossible even to guess at the expectancy of an individual trust beneficiary, but the term "Annuity Type of Trust" most certainly implies that a portion of the principal will have to be used each year to keep up the payments which have been designated in the trust for the life tenant.

The maker of an "Annuity" type of trust, we may conclude, therefore, differs from the maker of the "Fixed-Income" type in that the former deliberately plans a gradual reduction of principal, with no thought of restoration, while the latter

visualizes perhaps *temporary* withdrawals from principal, which he at least hopes will be replaced from earnings as time goes on.

C. The "Modernized" Type of Trust

The term "Modernized," as applied to a type of trust was a coinage of the author in his article, "A Modernized Trust Plan," which appeared in the April, 1937 issue of the magazine *Trust Companies.*

The "Modernized" conception conforms to the pattern of the "Fixed-Income" and "Annuity" types in that it contemplates withdrawals from principal, but it goes further than either of the others in the following respects:

1. It proposes not only to afford the life tenant a steady *dollar* income regardless of the actual earnings of the trust, but it also contemplates a change in payments to her in the event that the cost of living changes.
2. Instead of the customary "dollar conservation" method of investment, which is presumably to be employed in the management of the "Fixed-Income" and "Annuity" types, the "Modernized" conception envisages the "purchasing power preservation" method of investment management.
3. And lastly, if the annual withdrawals are not too great a percentage of the principal, the "Modernized" plan, under competent investment management, at least hopes, over each five or ten year investment cycle period, to offset withdrawals from principal with portfolio appreciation.

Today's investor, or testator, or prospective life tenant under a trust is confronted with a set of conditions which have had no parallel in American economic history. Our dollar has already been devalued by forty per cent, our governmental budget stands unbalanced year after year, while billions of dollars continue to be poured into the bottomless pit of managed economy. An heretofore never equalled base for credit has been laid. These three factors may not produce a marked degree of "inflation" with its concomitancy of increased living costs. There is probably still time to avoid it. On the other hand, however, there is undoubtedly a great deal of risk. Ten thousand dollars per year seems ample for Mrs. Smith *now;* but if living costs double during the next five to ten years, she will be just as badly off with her $10,000 income as she would be, were her cost of living to remain the same and her dollar income to be cut in two. It is this sort of contingency that the users of the "Modernized" form of trust envision. If Mr. Smith wants his wife to continue to live on her accustomed scale, he may, with the "Fixed-Income" or "Annuity" types of trust, be protecting her against only one eventuality—low interest rates—while the real pinch may come as a result of the lowered purchasing power of her dollars. It is with this thought in mind that the "Modernized" form provides for a variable income.

This change in *dollar* income may be worked out in several ways. One method might be to relate the life tenant's income to the cost of living index maintained by

the United States Bureau of Labor Statistics, or to some other similar index. The index figure on the date of the testator's death could be stated as parity for a $10,000 payment per annum to the life tenant. Annually thereafter, on each anniversary of the testator's death, the payments for the ensuing year could be increased or decreased by the same percentage that the index figure varies from the previous year.

An alternative plan, for the testator who has implicit faith in his wife's judgment and discretion, is to provide that she may, at her own discretion, withdraw as much principal as she needs for her comfort and support. This provision should of course be avoided in cases where there is any possibility that the life tenant may be vulnerable to the pleas of the indigent or the designing—relatives or others.

And then there is the situation of the testator who sees the investment management handicaps of leaving his wife *only* the *earned* income, but who prefers that she be favored or penalized, as the case may be, in the event that the value of the estate appreciates or declines. This sort of testator will provide that his wife receive a stipulated percentage *of the value of the estate* as it is appraised annually on the anniversary of his death. For example, in the case of the $200,000 Smith estate, Mrs. Smith, at five per cent would receive $10,000 the first year after her husband's death. If the estate appraised at $210,000 the next year, she would receive $10,500; but if it declined to $190,000, she would receive but $9,500. Thus, instead of being in conflict, as in the conventional trust, the interests of the life tenant and remaindermen are made identical. If the investment managers are able to increase the corpus of the trust, both the life tenant and the remaindermen profit. On the other hand, if the corpus of the trust declines, both the life tenant and the remaindermen must suffer.

As suggested in indented paragraph numbered "2" above, the "Modernized" type of trust visualizes the "purchasing power preservation" method of investment management, rather than the conventional "dollar conservation" method which is usually employed by trust companies. "Purchasing power preservation" demands experience, training, facilities and methods quite distinctive from those employed in "dollar conservation" and it is for that reason that the services of a trust company are frequently supplemented by those of competent investment counsel when the "Modernized" type of trust is employed. It is not to be inferred that investment counsel *must* be employed. The thought to be borne in mind is that many trust institutions are inexperienced in "purchasing power preservation."

Furthermore, the risk of surcharge is probably much greater. Before that type of management (purchasing power preservation) is entrusted to *any* organization—trust company or investment counsel—proof of its ability should be demanded.

Before closing, may the author remind the reader—especially the trustee reader—that the suggestions in this article, of course, can have no bearing upon trusts of the conventional, "*earned*-income-*only* to the life tenant" type which are now being administered? How such trusts are to be successfully managed, how adequate income is to be earned for life tenants, and how principal is to be conserved for remaindermen, are the problems of the trustees who (or whose predecessors) accepted that

type of trust. The question for the future, for every trust man and trust institution to ask him- or itself, is: "Are we going to continue to make the same mistake?"

Attorneys and testators too, it would seem, may well profit from the unfortunate experiences of trustees and beneficiaries under the conventional, "*earned*-income-*only* to the life tenant" type of trust, and, depending upon the circumstances surrounding each separate case, consider the "Fixed-Income," "Annuity," and "Modernized" types for their clients and their clients' future beneficiaries. This will require thought and time and work on the part of both attorney and testator. Too, it will at times seem that no plan can be devised which will exactly suit the particular requirements of the case at hand. Testators and attorneys should not be restrained or discouraged by such obstacles. They are common experiences. Perfection in a will or trust probably cannot be achieved. It is very difficult if not impossible to see twenty or thirty years ahead. The testator and his attorney, however, *can* avoid provisions which make investment management difficult, and intended benefits to beneficiaries impossible. They *can* create instruments which will be adapted to the particular circumstances, objectives and preferences of the testator—if they will devote time and thought to the problem instead of copying a standard form.[2]

[2] The limit of space in the above article has precluded the detailed observations the author would have liked to make both on the "Modernized" type of trust (including the advisability of the employment of the "purchasing power preservation" method of management by trust companies) and on the problem of selecting competent investment advisers. Sample will and trust clauses also might well have been introduced, had space permitted.

For those who may desire additional information, two other articles and an address by the author of this article will prove of interest.

"A Modernized Trust Plan," an article which appeared in the April 1937 issue of the magazine *Trust Companies.*

"Trust Service and Investment Counsel Service," an address before the Trust Division of the American Bankers Association at the Hotel Waldorf-Astoria, New York, on February 15, 1938.

"What to Look for and What to Disregard in Selecting Competent Investment Advisers," an article which appeared in the August 1936 issue of the magazine *Trust Companies.*

Reprints of the above, as well as sample will and trust clauses, may be secured, at no cost, by addressing the author in care of this publication or at 730 Fifth Avenue, New York City. ED.