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How to define income

There isn't a simple answer to the question of what constitutes the income of a trust.

"Trust income shall be paid to my wife at least annually, and the trust remainder shall be paid to my children at her death." That common phrase, familiar to generations of trust lawyers, sounds simple, but it is not. What is "income"?

In a traditional trust, income generally consists of interest and dividend payments. Price changes—capital gains and losses—affect the value of principal, and hence the value received by the remainder beneficiaries. For example, assume that a marital deduction trust invests in a technology stock that pays no dividends at all, but it doubles in price in five years. How much income does that create for the surviving spouse? None at all. A spouse who is looking for maximum reliable current income from trust assets likely would favor heavier investment emphasis on bonds and their regular interest payments, or dividend-paying stocks.

However, we have just come off of a period of historically low interest rates, in which an all-bond investing strategy might not yield enough income to satisfy a current beneficiary. What's more, failure to keep some exposure to equities in the trust portfolio could mean that the assets fail to hold their purchasing power during inflationary periods.

There are several alternatives to the traditional definition of trust income.

Continued on next page

The example of the charitable unitrust

When Congress became concerned in the late 1960s about a possible mismatch between the charitable deduction and the amounts that a charity actually might receive from a charitable trust, the resolution included a new statutory definition for a charitable income interest. Thus was born the *unitrust*, in which each year the income beneficiary receives a fixed percentage of the value of the trust assets, regardless of how those assets are invested.

During the 1990s, when interest and dividend rates fell to historically low levels, estate planners began to look to the unitrust model for private trusts as a way to resolve conflicts between income and remainder beneficiaries. At the same time, the Uniform Prudent Investor Act was introduced and began to be adopted around the country. That legislation provides standards by which trustees are measured in the discharge of their fiduciary duties in the investment arena. The new emphasis was less on the appropriateness of each individual trust investment, and more on the adequacy of the total trust return.

Thus was born the *total return trust*, a trust without a charitable beneficiary that follows the conventions of a charitable trust in determining what the income beneficiary gets.

The first state law authorizing the conversion of existing trusts to the total return format was enacted in June of 2001, and 17 states followed suit within three years. A majority of states also permit "equitable adjustment." In the earlier example of the no-dividend technology stock, a trustee could use equitable adjustment to allocate a portion of the stock's capital gains to the income beneficiary. Alternatively, during periods of high interest rates and high inflation, the trustee may allocate some income payments to the principal, to build the trust for the future.

Total return trusts are not a magical solution to investment management issues. They don't guarantee growth; they don't prevent losses. But they can ease conflicts among trust beneficiaries and meet beneficiary expectations by providing bright-line definitions of income.

IRS approval

Trusts have tax consequences, and in 2001, the Internal Revenue Service weighed in on total return trusts. Adjustments between income and principal that are consistent with state law will not impair the marital deduction, and a unitrust interest will qualify for the marital deduction if provided for by state law. Generally, the IRS considers that a unitrust interest of not less than 3% and not more than 5% is a reasonable apportionment of the total return of a trust. Existing marital deduction trusts may be converted to total return format under IRS regulations.

When "total return" is not paramount

The rigidity of the total return format may not be appropriate in all cases. See the table below for examples of alternative income definitions that estate planners have developed over the years. Situations in which a traditional trust may be satisfactory:

- ***Maximum return is not the goal of the trust.*** Some grantors are most worried about protection of capital and controlling investment risk.
- ***The surviving spouse is the primary beneficiary.*** A traditional trust that also permits discretionary invasions of principal to meet the spouse's needs will be adequate in many situations.
- ***The trust has a short time horizon.*** Because stock prices tend to be volatile over short time frames, increased equity exposure may not be appropriate for a trust with a short shelf life.

May we tell you more?

As you can see, modern trust design permits flexible trustee response for maximum financial security. If you and your family might benefit from trust-based financial management, we'd be pleased to tell you more about our services. Contact us to make an appointment this month to meet with one of our wealth advisors.☐

How should you define "income"?

You can be as flexible or as rigid as you wish in defining the claims of current and future beneficiaries to the assets of the trust that you establish.

With this kind of trust	The income beneficiary will get
Traditional trust	The interest and dividend payments
Total return trust	A fixed percentage of assets, determined annually
Indexed payout trust	A fixed dollar amount, adjusted for inflation each year
No-drop unitrust	A fixed percentage of trust assets, with a floor to protect income beneficiaries
Capped unitrust	A fixed percentage of trust assets, with a ceiling to protect remainder beneficiaries
Fully discretionary trust	Trustee decides each year what is best for all beneficiaries, taking into account their circumstances and financial market conditions

Source: M.A. Co.

Foreign exchange in inflationary times

For an introduction to foreign exchange, check the Big Mac index.

Investors who plan to add an international component to their portfolios need to understand something about exchange rates. An investment in foreign stocks or bonds offers an extra path for risk and for reward. In addition to the economic fundamentals that will drive the value of the investment, there is the possibility that changes in relative currency values will have an important effect on the bottom line.

Logically, exchange rates should not affect purchasing power around the world. When something costs $100 in Chicago or New York, a traveler ought to be able to exchange $100 for enough yen or euros to buy a similar item in Tokyo or Paris. Economists call this idea "purchasing power parity" (PPP).

In real life, logic doesn't always prevail. Each year, since 1986, *The Economist* magazine has constructed an index of purchasing power using a single commodity: the Big Mac. What started as a light-hearted guide for making exchange-rate theory more digestible has evolved over the years, and is now included in economics textbooks.

McDonald's hamburgers are sold around the world; their quality is consistent, but the prices are not, as shown in the accompanying table. All prices have been converted to dollars for easy comparison. Where the local price is above the U.S. price, the local currency is overvalued according to the theory of purchasing power parity. When the price is below ours, the currency is undervalued.

The first column gives the local prices of the Big Mac converted to dollars. Comparing these provides a measure of how overvalued or undervalued a foreign currency is relative to the dollar.

Although the Big Mac index is subject to some distortions by local sales taxes, trade barriers and other factors, *The Economist* reports that its PPP estimates are remarkably close to those derived by more sophisticated methods. The data show that the dollar has been strengthening against other world currencies in recent years.

Inflation has caused the median price of a Big Mac in the U.S. to rise by 6% in the last two years, according to the article. Other countries have experienced even more inflation than we have, but the effect has been offset by the changing currency relationships. For example, two years ago the Big Mac was 26% cheaper in Japan, and now it is 41% cheaper.

Big Macs around the world

Country	Big Mac price, in dollars	Distortion
Switzerland	7.26	+ 35%
United States	5.36	
Euro area	5.27	- 2%
Mexico	4.19	- 22%
China	3.54	- 34%
Japan	3.15	- 41%

Source: *The Economist,* January 26, 2023

Caution for investors. The volatility in currency exchange rates is just another difficult fact of life for investors, one that adds both risk and reward to the international component of an investment portfolio. Although it may be important for investors to have a global perspective, it's also important to stay well diversified, not concentrated in a single country or region. ☐

Reminders for 2022 tax returns

Although there were no major changes taking effect for individual taxpayers during the 2022 tax year, there are a few minor wrinkles to keep in mind.

Delayed deadline. Tax returns are due on April 18 this year, rather than April 15. The 15th falls on a Saturday, and the next business day, April 17, is the Emancipation Day holiday in Washington, D. C. Hence, the due date becomes Tuesday, April 18. Taxpayers who live in disaster areas may have until May 15 to file their returns. State-specific details may be found on the IRS website at https://www.irs.gov/newsroom/tax-relief-in-disaster-situations.

Reduced child tax credit. In response to the pandemic, the child tax credit was temporarily increased to $3,600 for children five and under, $3,000 for those ages six through 17. The increase was not renewed for 2022, so the credit went back to $2,000 per qualifying child.

Charitable deductions. There is no longer a supplemental charitable deduction permitted for those who use the standard deduction. The suspension of certain limits on the charitable deduction for itemizers was not renewed.

State payments. Some 21 states made payments to citizens in 2022 in connection with the pandemic. In a late-breaking announcement, on February 10, the IRS stated that most of these payments do not have to be included as income for 2022 tax returns. The determination was made in the interest of sound tax administration, and applies only to the 2022 tax year, as the pandemic emergency will end in May 2023, the IRS said.

In Georgia, Massachusetts, South Carolina, and Virginia, the payments were refunds of state taxes paid. In those states, the payment is taxable if it generated a tax benefit. If there was no tax benefit, either because the taxpayer used the standard deduction or because the $10,000 cap on the deduction for state and local taxes applied, the payment is not taxable.

In Alaska, California, Colorado, Connecticut, Delaware, Florida, Hawaii, Idaho, Illinois, Indiana, Maine, New Jersey, New Mexico, New York, Oregon, Pennsylvania and Rhode Island, the payments were for the promotion of the general welfare or for disaster relief. As such, they may be excluded from income for 2022.

Note that Illinois and New York had both types of payments. Taxpayers who received both payments will need to apply both rules. Note also that the exclusion from income does not apply to the Permanent Fund Dividend from the state that Alaskans receive.

Complete details may be found at https://www.irs.gov/newsroom//irs-issues-guidance-on-state-tax-payments-to-help-taxpayers.

Taxpayers who included state payments in taxable income on returns filed before the February 10 IRS announcement may file an amended return for a refund. Consult your tax advisors to learn more. ☐