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Change in smoothing rule for private unitrusts presents timely opportunities for net income trusts

By R. Douglas DeNardo, Esq. and Karen E. Bononi, Esq.

Trusts that provide an income stream to a current beneficiary (net income trusts) are very common in estate planning and have been so for the better part of the past century. In fact, many trusts that were drafted in the 1950s, 60s and 70s provided a beneficiary with the income only from a trust with no access to the trust principal. Back then, interest rates were much higher than they are now and the income from a trust could provide a decent standard of living. Nowadays, however, income is next to nothing.

Because interest rates are at historical lows, net income trusts present a conundrum for trustees who are trying to be fair to both the current beneficiary and the remaindermen. The current income beneficiary will want the trust to be invested in assets that will produce the highest possible income. Unfortunately, these are assets that traditionally do not appreciate in value. Remaindermen, on the other hand, want the assets invested in high growth vehicles that typically do not produce any income. Since the trustee is required to be equitable to both the income beneficiary and the remaindermen, this generally results in everyone being a bit unhappy. To rectify this conflict between the needs of the current income beneficiaries and those of the remaindermen, Pennsylvania passed Senate Bill 1014.

Highlights

Senate Bill 1014 allows conversion of a net income trust to a 4% unitrust.

Senate Bill 53 allows the smoothing period to be changed from three years to three, four or five years.

The law authorizes the conversion of a net income trust to a four percent (4%) private unitrust. This means that income is redefined as four percent of the value of the trust assets on a three year rolling average rather than the traditional interest and dividend income

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definition. The conversion may be accomplished at the request of either the income beneficiary or the trustee (without the necessity of going to court) if notice is given to all beneficiaries and no one objects within sixty (60) days of such notice. Your Rothman Gordon attorney can generate a letter to give such notice.

If any beneficiary objects within such sixty (60) day period, the beneficiary and trustee must then present a petition to the court for approval of the conversion.

Under prior law, the unitrust percentage was applied to the average value of the trust over the past three years. Rothman Gordon's estate department generally uses the closing value of the trust at the end of each year to determine the average value of the trust assets. In the first year of the trust, it distributes an amount equal to four percent (4%) of the value of the trust at the close of business of the previous year (generally December 31). For the second year, the average of previous two years is used and in each year thereafter the average of the prior three years is used. Utilizing the average values over a three year period "smooths" the income to the beneficiary and avoids spikes due to upturns or downturns in the market.

In addition to stabilizing the income to the current beneficiary, converting the trust to a unitrust also provides an opportunity for the trustee to invest trust assets for "total return." As discussed above, a trustee of a net income trust would invest a large portion of the assets of a trust in fixed income investments or in securities which produced some income. A small portion, if any, of the trust assets would have been invested in pure growth stocks. This makes the income beneficiary happy since the maximum income is being derived from the trust assets. Although the value of the trust assets may increase slightly under this investment mix, the increase might have been much greater had it been invested for total return that allows a larger portion to be invested in growth securities.

As an added incentive, and another option for those who have already created a unitrust, Pennsylvania Senate Bill 53 allows the changing of the smoothing term from three years to three, four or five years at the discretion of the trustee. (If a beneficiary wants to change the smoothing terms, he or she must petition the Court per 8105(g)(3) to average the valuation of net assets over a period other than three years.) Governor Edward G. Rendell signed the bill into effect on October 27, 2010. To illustrate the advantages, let's compare a \$1,000,000 trust as of December 31, 2005 and compare its value assuming it was based on the S&P 500 value as of that date and the value of the S&P 500 at the end of 2005, 2006, 2007, 2008 and 2009.

	Three-year smoothing	Five-year smoothing
2005		1248.29
2006		1418.03
2007	1411.63	1411.63
2008	931.80	931.80
2009	1115.10	1115.10
Smoothed value:	1152.84	1211.36

Calculations are based on the last Friday of each year.

The estate attorneys at Rothman Gordon believe a unitrust is an excellent option for clients who are trying to balance the assets given to the beneficiary with the assets to be given to the remaindermen. With the recession's effects still being felt, we believe a unitrust smoothed over five years negates some of the oscillations of the market. If you are interested in more information on either converting an income trust to a unitrust or changing the smoothing term for an existing unitrust, please contact your Rothman Gordon attorney or you may call me directly at (412) 338-1140 or email me at ddenardo@rothmangordon.com. We are required by Treasury Regulations to advise that this writing is not intended as a reliance opinion and cannot be used for purposes of avoiding IRS penalties.

Rothman Gordon a sponsor of the 2010 Pittsburgh 100

On August 26, 2010, Rothman Gordon joined the *Pittsburgh Business Times* for our fifth year of sponsoring the Pittsburgh 100, a list of the 100 fastest growing private companies in Western Pennsylvania. Even the recession could not stop these local companies and it was thrilling to see old friends, new names and clients on the list.



Jason Laura of Confluence and Ellen Ruddock of IUP Center for Family Business.



John Gatesman and Dave Krasnick of Gatesman Marmion Drake + Dave and Bill Lestitian.

In the News...

Eleven Rothman Gordon Attorneys Named to Best Lawyers in America

Rothman Gordon is proud to announce that 11 of its attorneys have been named to the 2011 edition of Best Lawyers®. They include: Thomas R. Solomich and Samuel L. Douglass for Real Estate Law; Shelley W. Elovitz and John W. Zatkos, Jr. for Workers' Compensation Law; K. Sidney (Casey) Neuman, James W. Ummer and R. Douglas (Doug) DeNardo for Trusts and Estates; and Stephen H. Jordan, Alan C. Blanco, James W. Carroll, Jr., and Louis B. Kushner for Labor & Employment Law. Louis was also listed for Alternate Dispute Resolution and Sam was also listed for Natural Resources Law and Mining Law.

First published in 1983, Best Lawyers is based on an exhaustive annual peer-review survey. For the new U.S. edition, more than 50% of the lawyers listed in Best Lawyers cast more than 3.1 million votes on the legal abilities of other lawyers in the same and related specialties. Because of the rigorous and transparent methodology used by Best Lawyers, and because lawyers are not required or allowed to pay a fee to be listed, inclusion in Best Lawyers is considered a singular honor. Corporate Counsel magazine has called Best Lawyers "the most respected referral list of attorneys in practice."



Bill Lestitian Appointed Chair-Elect to ACHIEVA Board of Directors

Bill Lestitian has been appointed as Chair-Elect of the 2010-2012 Board of Trustees for Achieva, the largest nonprofit organization in Western Pennsylvania serving adults and children with disabilities and their families.



Colleen Ramage Johnston Elected Chair of Labor & Employment Section

Colleen Ramage Johnston has been elected Chair of the Labor and Employment Law Section of the Allegheny County Bar Association.

Renovations at the office

The next time you are in Rothman Gordon's offices, you may notice a few changes. With our new neighbor, Huntington Bank, moving in to the fourth floor of the Grant Building, the center of our third floor office space will become a construction zone as the building makes improvements and structural changes. Some of our attorneys and conference rooms will be temporarily relocated to the 8th floor.

While the changes, which are estimated to take between four and six months, will be inconvenient, we are confident that the improvements will be well worth the hassle. In the long-term, Rothman Gordon is looking forward to new office amenities, conference space and an improved reception area with natural light.

We appreciate your patience and understanding during the transition and we look forward to showing off our new space in the spring.

We're on YouTube!

Rothman Gordon has taken the plunge and is trying social media. If you go to www.youtube.com and search for Rothman Gordon, you will find three videos that feature our attorneys sharing information that we believe is of interest to the general public.

Shelley Elovitz appears in *An Introduction to Workers' Compensation* and *Workers' Compensation Claims*. Both short videos give tips on what steps to follow if you are injured on the job or if you file a claim.

Sam Douglass appears in *Marcellus Shale for Landowners*. In this video, Sam discusses some of the issues to consider for landowners who may be approached about leasing their land for drilling.

Our videos were mentioned in Joyce Gannon's October 18th article "Web communications and social media in law firms' toolboxes" which appeared in the *Pittsburgh Post-Gazette*.

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