WHITE PAPER NO. 28

GOOD NEWS FOR PENNSYLVANIA BENEFICIARIES: THE PRINCIPAL AND INCOME ACT OF 2002

GREYCOURT

White Paper No. 28 – *Good News for Pennsylvania Trust Beneficiaries: The Principal and Income Act of 2002*

The Uniform Principal and Income Act was first promulgated back in 1997, but it wasn't until July of this year that the Pennsylvania legislature got around to enacting it. But better late than never. The purpose of this white paper is to outline the key provisions of the Act and to explain why it is so significant for trusts, trustees and, most important, trust beneficiaries.[1]

The Principal and Income Act, which became law in Pennsylvania on July 15, 2002, applies to all Pennsylvania trusts unless the language of the trust instrument specifically exempts the trust from its provisions.[2] The Act contains three sections. The first section, which is least important for purposes of this discussion, simply specifies what is "principal" and what is "income" for trust purposes. Most trusts are quite specific in separating principal from income, allocating principal to one group of beneficiaries and income to another group. Hence, it is important that there be no confusion over what belongs to whom.[3]

Total return trusts

The second part of the Act covers the "power to adjust," thus allowing trustees to recategorize "principal" as "income" or vice versa as necessary to achieve fairness as between income and principal beneficiaries. This seemingly simple grant of authority is actually a crucial breakthrough in allowing trusts to be properly managed, that is, on a total return basis.

Consider what has been happening with the management of trusts over the past several decades. Since the "stagflation" era ended in the early 1980s, the developed world has lived in an era of very low dividend and interest rates. In such an environment, trustees have found it necessary to invest very substantial percentages of trust assets in fixed income securities in order to generate anything approaching a reasonable payout level for income beneficiaries. But such large bond exposures have dramatically

[1] Both the Pennsylvania and other state Principal and Income Acts are based on the Uniform Act. However, each state has modified the Uniform Act in minor or major ways. For example, many states have adopted the provisions of the Uniform Act that establish the power to adjust but have not adopted the unitrust provisions.

[2] Since existing trusts were drafted before the enactment of the Uniform Act, it will be a rare existing trust that is exempt from the provisions of the Act. However, specific provisions in a trust document can override specific provisions in the Act.

[3] The distinctions between principal and income may seem self-evident, but in today's complex financial world it is not always clear how a particular asset or fund flow should be categorized, and reasonable trustees might differ about the proper classification. For example, the Pennsylvania Act allocates short term capital gains from mutual funds to principal, while the Uniform Act (and the IRS) allocate such gains to income.

reduced the long-term investment returns of trust assets, resulting in significant harm to the ultimate principal beneficiaries. On the other hand, in cases where trustees have invested for the long-term (that is, seeking strong growth of principal, which makes principal beneficiaries happy), trust yields have often fallen below 2% – not much of a payout and not a happy circumstance for income beneficiaries.

The "total return" section of the Principal and Income Act addresses this problem by encouraging trustees to adopt a total return invest approach – i.e., to invest for long-term growth. This will keep principal beneficiaries happy. But the Act also allows trustees to recharacterize principal as income and to pay it out to income beneficiaries. Thus, if the trust is yielding only 2% because it is invested for the long-term, the trustee can take, say, another 2% out of "principal," reclassify it as "income" and pay it out to the income beneficiary.[4] The trustee doesn't have to change the investment strategy to meet the income needs of current beneficiaries.

The Uniform Act (not the Pennsylvania Act) has comments which describe circumstances under which the exercise of the power to adjust would be proper. Trustees and beneficiaries may find these examples useful. One example follows:[5]

> Trustee Bank B is the successor trustee of a trust that provides income to Mary for life, with the remaining principal passing to Mary's children at her death. Trustee Bank A, which had previously managed the trust, had created a portfolio invested 20% in stocks and 80% in bonds. Following the prudent investor rule, Trustee Bank B determines that a strategy consisting of 50% stocks and 50% bonds would have risk and return objectives more reasonably suited to the trust. However, Trustee Bank B also recognizes that adopting this approach will cause the trust to receive a smaller amount of dividend and interest income, thus reducing distributions to Mary. After considering the factors in §8104(b) [that is, the issues the trustee may consider in deciding whether to exercise the adjustment power], Trustee Bank B may transfer cash from principal to income to the extent that Trustee Bank B considers it necessary to increase the amount distributed to Mary.

Unitrusts

Under the Act's total return approach, a trustee must decide *on each occasion* whether or not to recharacterize principal or income. But part three of the Act offers another option, namely, the option to convert the entire trust to a "unitrust." Under this technique, the trustee decides one time to operate the trust as a unitrust, and thereafter the distinction between income and principal no longer matters for payout purposes.[6] In order to effect the conversion, the trustee must determine that the conversion will enable it to better carry out the intent of the creator of the trust. The trustee must also give notice to the beneficiaries of its intent to

[4] The Act specifies the what issues the trustee may consider in deciding whether to exercise the power to adjust. See the PEF Code §8104.

[5] I have slightly modified the language of this example to make it easier to follow.

[6] The issues the trustee may consider in converting to a unitrust are the same as those used to decide whether to adjust income and principal.

convert to a unitrust and must specify how the unitrust would operate.[7]

Once a trust has been converted to a unitrust, the trust must be operated on a total return basis. The payout is thereafter defined as being a percentage of the trust's value, and that percentage is paid out, regardless of whether the payout comes from what would traditionally have been considered "income" or from what would traditionally have been considered "principal." Indeed, the word "income" in the governing trust agreement is thereafter interpreted not to mean interest and dividends but to mean *an annual distribution equal to 4% of the fair market value of the trust's assets*. The fair value is computed net of all expenses and is determined by a three-year average of the value of the trust's assets. Note that a trustee cannot pay out more or less than 4% without seeking a court order.

Protection of the trustee

The power to adjust, or to convert to a unitrust, are obviously quite new powers for trustees. Therefore, notwithstanding the immemorial history of the trust concept, there is little legal precedent defining how the new powers should operate. In recognition of this fact, the Act provides that courts should not disturb a trustee's decision unless it is determined that the trustee abused his discretion – a very high standard.[8]

Moreover, even in cases where a court determines that a trustee abused his discretion, the remedies are limited, namely, to restoring the beneficiaries to the positions they would have been in had the trustee not abused his discretion. Damages may be awarded against a trustee only if there is no other way to make the beneficiaries whole.

Working with your trustee

Trust departments tend to be the most cautious and conservative groups in any financial institution. Many trust departments are operated today not much differently than they were operated half a century ago (except for the use of computers). Hence, the notion that trustees are going to be rushing to exercise powers to adjust or to convert to unitrusts is, to say the least, unlikely. Beneficiaries who see total return investment strategies as being in their interests – that is, virtually all beneficiaries – will have to be proactive in bringing the possibility to the attention of their trustees. In some cases, beneficiaries will have to be considerably more than proactive – making it clear, through their attorneys, if necessary, that adopting a total return approach is decidedly in the interests of all beneficiaries and that failing to do so would be an abuse of discretion. Beneficiaries who have the power to change the trustee will obviously have more clout than others. Another development that is likely to occur is that more modern trustees, who are willing and eager to move to total return approaches, will use the new Act to gain market share versus more outmoded firms.

We will be happy to discuss this memo at your convenience.

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[7] PEF Code §8105(a)(4).

[8] In other words, the mere fact that the court believes the trustee was wrong is insufficient to overrule the trustee. The trustee's decision must be found to be beyond the bounds of reasonableness.

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