► **Greycourt White Paper**

White Paper No. 15 – *Total Return Trusts*

From the time the concept of the trust was first developed in the late Middle Ages until about the 1950s, trust assets tended to produce far more income than capital appreciation. The long-term result was typically that early income beneficiaries fared well, while later income beneficiaries and principal beneficiaries fared poorly. (The decline of the English aristocracy was prominently fueled by this quiet phenomenon.)

All that began to change half a century ago, and by the end of the 20th century many sensibly invested trusts were yielding well under 2%. Today, therefore, the problem has reversed itself. Sensibly invested trusts – that is, those with predominantly equity-oriented portfolios – tend to appreciate handsomely over time, but they produce little in the way of current yield in our low-dividend, low-interest-rate environment.

Properly drafted trusts can easily deal with this problem by providing both a floor and a ceiling for payouts to current income beneficiaries.[1] But what about the hundreds of thousands of trusts that were drafted years ago? State legislatures, under pressure from the legal and financial community and from income beneficiaries, have grappled with this issue, and roughly half the states now address it in one of two ways.

The Uniform Principal and Income Act. The UPIA, adopted in 1997, allows trustees to adjust distributable income by transferring principal to income or income to principal as required to achieve fairness as between income and principal beneficiaries. The UPIA applies only to trusts that calculate the payout to beneficiaries by reference to "net income." The UPIA, or a version of it, has been adopted in twenty-four states and another three or four have the Act under current review.

Under the UPIA approach, a trustee can invest the trust assets in any manner that is prudent, without regard to how much "net income" the trust will generate. Then, if the income is so low as to be unfair to the income beneficiaries, the trustee can make an adjustment by transferring principal to income and making a larger income distribution. If the income is so high as to be unfair to the ultimate principal beneficiaries (an unlikely situation these days), the trustee can transfer income to principal and make a smaller distribution. A provision added to the UPIA in 2000 limits trustee liability for making good faith adjustments.

[1] We could debate the appropriate payout level endlessly, but most sophisticated observers (including Greycourt) would set trust payouts at between 3% and 4%, depending on how aggressively invested the principal portfolio may be. Though it may seem counterintuitive, the more aggressive the investment strategy is (within reason), the higher the payout can be.

Unitrust legislation. Another approach, adopted by four states and under consideration by another eight, permits trustees of net income trusts to convert those trusts to unitrusts. In a unitrust, distributable income is specified as a percentage of the trust assets as those assets appreciate or depreciate annually. Hence, a trustee can invest the trust assets in any manner that is prudent, then pay out a specified percentage of the trust value without regard to whether the payout includes income, principal, or both.

Note that a few states, notably New York, have adopted *both* approaches, giving trustees the choice of which to pursue. The attached exhibit lists those jurisdictions which are known to us to permit total return approaches.

The IRS view. The Internal Revenue Service has issued proposed regulations that endorse both the unitrust and UPIA models. Hence, the IRS will honor total return approaches to all trust, including such trusts as marital trusts and generation-skipping trusts, in states that have adopted total return legislation. Importantly, the IRS provides a safe harbor only for total return payouts between 3% and 5%.

Total return trusts in states without total return legislation. Newly drafted trusts can adopt total return approaches regardless of state laws. But what about older trusts domiciled in states that have not adopted total return legislation of any kind? There are two possible solutions for these trusts:

* *Resorting to discretionary principal distributions*. Many net income trusts authorize the trustee, in its discretion, to make principal distributions to income beneficiaries. Some trustees, particularly if they feel that they may otherwise lose the business, will use their discretionary power to distribute principal to augment low income distributions. If a trustee is recalcitrant, many trusts permit the trustee to be removed and replaced by an institution with more modern outlook.
* *Moving the domicile*. If necessary, the domicile of a trust can be moved to a jurisdiction that permits a total return approach. Court approval may be required in some cases.

Conclusion. The desire to have a trust managed on a total return basis is only one of many considerations in judging a trustee's performance. However, our experience has been that trustees who refuse point blank to explore approaches that make simple common sense are likely also to be undesirable from many other points of view.

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

GREYCOURT & CO., INC.
April 2002

(This paper was written by Gregory Curtis, Greycourt's Chairman.)

► **Greycourt White Paper**

April 2002

White Paper No. 15: *Total Return Trusts – Exhibit A*

States that Have Adopted or Are Considering the UPIA Approach

Alabama
Arizona
Arkansas
California
Colorado
Connecticut
District of Columbia
Hawaii
Idaho
Indiana**
Kansas
Louisiana
Minnesota
Missouri•
Nebraska
New Jersey
New Mexico
New York•
North Dakota
Oklahoma
Rhode Island**
South Carolina
Tennessee
Vermont**
Virginia
West Virginia
Wyoming

States that Have Adopted or Are Considering the Unitrust Approach

Alaska*
Delaware
Illinois*
Indiana**
Iowa*
Maryland*
Missouri•
New York•
Pennsylvania*
Rhode Island**
South Dakota
Vermont**

* Under consideration.
• Has adopted both approaches.
** Both approaches under consideration.