WRMarketplace

An AALU Washington Report

The *WR Marketplace* is created exclusively for AALU members by experts at Greenberg Traurig and the AALU staff, led by Jonathan M. Forster, Steven B. Lapidus, Martin Kalb, Richard A. Sirus, and Rebecca S. Manicone. *WR Marketplace* #17-37 was written by Greenberg Traurig Shareholder Karen D. Yardley.

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TOPIC: Attention Trustees: Better Understand the Uniform Principal and Income Act.

MARKET TREND: Trustees need to be aware of how investments impact income and principal available to beneficiaries as litigation against trustees continues.

SYNOPSIS: Allocation of revenues ("receipts") and costs and expenses ("disbursements") between trust income and principal can directly impact beneficiaries and their rights to distributions. To assist trustees with treating beneficiaries fairly and impartially, most states have adopted a version of the Uniform Principal and Income Act ("UPIA") to provide direction regarding the allocation of receipts and disbursements between competing income and principal interests. Strict application of basic UPIA rules, however, can create additional problems. Advisors should be aware of techniques that work around those problems and may achieve better parity among beneficiaries.

TAKE-AWAYS: Trusts may serve a variety of purposes, such as providing an income stream for beneficiaries, preserving family assets for future generations, or providing creditor protection. The trust's purpose impacts the design of its beneficial interests and investment of its assets. UPIA provides a structure for allocating revenues and expenses between trust income and principal and can offer clarity between competing trust interests. UPIA, however, is not a "one size fits all" solution. Strict application of UPIA's basic rules can result in inequities among beneficiaries and impact trust investments. Trustees can overcome these inequities by accounting separately for certain trust activities, making adjustments between income and principal to avoid favoring certain beneficiaries, or converting a mandatory income trust into a unitrust.

MAJOR REFERENCES: Uniform Principal and Income Act (2008).

Beneficial interests in irrevocable trusts vary greatly – certain beneficiaries may have a right to only trust income, others to just principal, and others to both income and principal. These differing interests can create conflicts and influence the administration and investment of the trust. To assist trustees with treating beneficiaries fairly and impartially, most states[1] have adopted a version of UPIA to provide direction regarding the allocation of receipts and disbursements between competing income and principal interests. As strict application of basic UPIA rules can create additional problems, however, advisors should be aware of "work-arounds" that may achieve better parity among beneficiaries.

COMPETING BENEFICIAL INTERESTS

Trusts can differ greatly with respect to the assets they hold, not only in terms of the asset type (e.g., a concentration in business interests or real estate, or a mix of marketable and non-marketable assets), but also with regard to whether those assets produce income. Differing beneficial interests in the same underlying trust assets can create conflicts and impact the trust's administration and investment decisions.

> ***Example*:** Upon H's death, his revocable trust creates a marital trust for the benefit of W. W will receive the net income annually for her lifetime and, after her passing, the trustee will distribute the principal to H's children from a prior marriage. The trust structure generates competing beneficial interests: W, as the income beneficiary, wants to maximize the marital trust's income, but H's children, as remainder beneficiaries, want to maximize the principal that will remain in the trust after W's passing. This conflict places the trustee in a difficult position when making investment choices.

A "ONE SIZE FITS ALL" SOLUTION: UPIA

To address conflicting trust interests objectively and treat beneficiaries fairly and impartially, UPIA provides a complex set of rules for allocating receipts (interest, dividends, rents, and insurance proceeds) and disbursements (trustee and accounting fees, investment fees, taxes, and other administrative expenses) between income and principal, generally based on three guiding principles:

First: The trustee allocates receipts and disbursements in accordance with the terms of the trust.[2]

Second: If the trust does not address a particular item, then the receipt or disbursement is allocated in accordance with UPIA's rules (see Appendix A for a list of common receipts and disbursements and their typical allocation between income and principal under UPIA).[3]

Third: If neither the terms of the trust instrument nor UPIA provides a rule for allocation, then the receipt or disbursement is allocated to trust principal.[4]

- ***Practical Note***. The ***first principle grants advisors and clients immense leeway to deal with specific concerns when structuring the trust*** rather than defaulting to UPIA's rules. For example, to maximize income, the trust instrument could direct allocation of all capital gains to income or allocation of certain expenses to principal.

WHAT IF UPIA DOESN'T "FIT"? OPTIONS FOR CUSTOMIZATION

As noted, trusts differ as to how and when income and principal may be distributed to beneficiaries, the mix of trust assets, and the ability to restructure trust investments. Given this wide disparity in trust structures, strict application of UPIA's allocation rules for receipts and disbursements may not meet a given trust's specifics needs, possibly causing some beneficiaries to bear the burden of ongoing expenses while allowing others to reap the benefits.

Fortunately, for trusts relying on UPIA's rules, UPIA provides mechanisms that allow trustees to provide separate accounts for certain business activities and to make adjustments between income and principal when appropriate. In addition, certain states have enacted statutes that authorize trustees to convert income-only trusts into unitrusts to provide greater investment flexibility.

Separate Accounting for Businesses and Other Activities. Under UPIA, money received is generally allocated to income and, if income is required to be distributed, passed out to the beneficiaries. In such situations, strict application of the basic UPIA rules would leave no funds to operate or maintain a business, rental property, or other activity. Special provisions in UPIA, however, authorize a trustee who operates a business or other activity as a proprietorship to account separately for the business/activity, enabling the trustee to retain part of the cash receipts for working capital, repairs, replacement of assets, and other needs. The trustee also is authorized to determine the extent to which the remaining cash receipts are allocated between income and principal. Activities for which a trustee may account separately include retail, manufacturing, service and other traditional business activities, management of rental properties, and farming.[5]

> ***Example***: Trust T, an irrevocable trust, owns and manages several rental properties operated as a sole proprietorship. Under general allocation rules, the entire net rental income is allocated to trust income, leaving nothing for the payment of repairs and other property expenses. If the trustee elects to account for the activity separately, the trustee can set aside reserves for the payment of property expenses and can determine what portion of the remaining rental payments are allocated to income.

The ability to account for certain business and other activities separately can allow a family to continue operating, and to even expand, a family business or activity rather than allowing the asset to deteriorate or being forced to sell the enterprise.

Power to Adjust Between Income & Principal. Another powerful UPIA provision gives the trustee authority to adjust between income and principal if: (i) the trustee manages trust assets as a prudent investor, (ii) the trust's terms describe the amount that may or must be distributed to a beneficiary by referring to the trust's income, and (iii) the adjustment is necessary to administer the trust impartially based on what is fair and reasonable to all beneficiaries.[6] In determining whether and to what extent to exercise the power of adjustment, the trustee must take a number of factors into consideration, including the settlor's intent, the nature, purpose, and expected duration of the trust, the identity and circumstances of the beneficiaries, the assets held in the trust, the need for liquidity, regularity of income and preservation and appreciation of capital, and the anticipated tax consequences of an adjustment.[7]

> ***Example*:** T is the trustee of a trust whose portfolio includes a large parcel of undeveloped real estate. T pays real property taxes on the undeveloped parcel from income each year. After considering the return from the trust's portfolio as a whole and other relevant factors, T may exercise the power to adjust to transfer cash from principal to income so that T can distribute to the income beneficiary an amount that T considers necessary to be impartial and fair to all the trust's beneficiaries.

Conversion to a Unitrust. Income-only trusts (i.e., trusts that require distribution of all income to certain beneficiaries but do not authorize principal distributions) can create particularly thorny issues for trustees. Income beneficiaries generally want to maximize income, and remainder beneficiaries generally want to maximize the growth of trust principal.

While not part of UPIA, a number of states (including California, New York, Florida, and Illinois) have enacted provisions authorizing the conversion of a trust that mandates the distribution of net income annually into a unitrust. The unitrust payment is generally determined annually as a percentage (set out in the statute) of the net fair market value of the assets. Conversion of a trust into a unitrust enables the trustee to make regular unitrust distributions (in lieu of net income) to the beneficiary, permitting the trustee to invest trust assets for growth rather than income in accordance with the prudent investor statute and negating the need to make income and principal adjustments in order to treat beneficiaries equally and impartially.

> ***Example*:** Upon H's death, his revocable trust creates a trust benefiting his child, X. The trust provides that X will receive net income annually for life. At X's passing, the trust distributes remaining principal to X's children. The trust estate consists primarily of marketable securities. To generate income for X, the trust has been invested mainly in bonds and stocks that pay dividends. However, interest rates have dropped and dividends have been declining. The investment structure also restricts the growth of the trust estate. If the trustee converts the trust to a unitrust, X can receive a percentage of the value of the trust's assets, allowing the trustee to invest for growth rather than income.

The rules regarding when a conversion is authorized, whether court approval is required, and the steps required to convert a trust to a unitrust vary by state and must be carefully analyzed before proceeding.

TAKE-AWAYS

- Trusts may serve a variety of purposes, such as providing an income stream for beneficiaries, preserving family assets for future generations, or providing creditor protection. The trust's purpose impacts the design of its beneficial interests and investments of its assets. UPIA provides a structure for allocating revenues and expenses between trust income and principal and can offer clarity between competing trust interests.

- UPIA, however, is not a "one size fits all" solution. Strict application of UPIA's basic rules can result in inequities among beneficiaries and impact trust investments. Trustees can overcome these inequities by accounting separately for certain trust activities, making adjustments between income and principal to avoid favoring certain beneficiaries, or converting a mandatory income trust into a unitrust.

Appendix A: Common UPIA Allocation Rules

The following charts illustrate how common receipts and disbursements are generally allocated between income and principal under UPIA.[8]

Allocation of Receipts

Type of Receipt	Allocation to Income	Allocation to Principal
Interest	100%	
Payments on principal on a debt/obligation owed to trust		100%
Dividends	100%	
Rents	100%	
Rental deposits and proceeds from sale/exchange of rental property (incl. capital gain)		100%
Royalties	100%	
Insurance Proceeds		100%
Insurance Dividends: **Premium Paid from Income** **Premium Paid from Principal**	 100% 	 100%
Money received from an entity	100%	
Property received from an entity		100%
Proceeds from sale of an asset (incl. capital gain)[9]		100%
Annuities, Retirement Plans, and Other Deferred Compensation[10]	To the extent characterized as income by payor,[11] otherwise (i) 10% of any required payment, or (ii) nothing if payment is not required[12]	Balance

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Allocation of Disbursements

Type of Disbursement	Allocation to Income	Allocation to Principal
Trustee fees	50%	50%
Accounting fees	50%	50%
Investment advisor fees	50%	50%
Ordinary expenses in administration, management, and preservation of trust property	100%	
Judicial proceeds that involve both income and remainder interests	50%	50%
Judicial proceedings construing or protecting trust property or concerning primarily principal		100%
Judicial proceedings concerning primarily income	100%	
Principal portion of mortgage or other trust debt payments		100%
Interest portion of mortgage or other trust debt payments	100%	
Ordinary repairs	100%	
Property insurance premiums	100%	
Property management expenses	100%	
Tax on ordinary income	100%	
Tax on capital gain		100%
Gift, estate, and generation-skipping transfer taxes and penalties		100%
Property taxes	100%	

NOTES

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This information is intended solely for information and education and is not intended for use as legal or tax advice. Reference herein to any specific tax or other planning strategy, process, product or service does not constitute promotion, endorsement or recommendation by AALU. Persons should consult with their own legal or tax advisors for specific legal or tax advice.

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[1] UPIA §103(b). Various versions of UPIA have been promulgated since 1931, with the last set of revisions and amendments made by the Uniform Las Commission in 2008. References in this WRMarketplace to UPIA are to UPIA as revised and amended in 2008.
[2] UPIA §103(a)(1)-(2).
[3] UPIA §103(a)(3).
[4] UPIA §103(a)(4).
[5] UPIA §403.
[6] UPIA §104(a).
[7] UPIA §104(b).
[8] *See* UPIA §§501-502.
[9] UPIA §405.
[10] Note that special rules apply if the payment is made to a marital deduction trust. *See* UPIA §409(f).
[11] UPIA §409(b).
[12] UPIA §409(c).