WHERE THERE'S A WILL

The revolution is underway
"Total return trusts" come to Tennessee

By Dan W. Holbrook

What client would want a trust that created inherent conflicts among beneficiaries and tended to produce poor investment results? Yet we lawyers have done these for our clients for centuries. Fortunately, the revolution has come.

In law school we learned that a trust is merely the separation of legal title from equitable title. This simple concept, like the invention of the numeral zero, has had a dramatic impact on our society. Trusts accomplish many socially desirable purposes available no other way.

But trusts can have a dark side when they fail to anticipate future changes.

Consider the all-too-common example of an "income-only" trust. Dad dies, leaving his estate in trust for Mom for life, remainder to Junior. Mom is to receive all income for life. A conscientious trustee faces a terrible dilemma. He has a fiduciary duty on the one hand to Mom to provide adequate income, and on the other hand to Junior to protect, and even grow, the principal. Over the last 50 years the S&P 500 has returned over 13 percent per annum, while government bonds and treasury bills have returned over 5 percent, and the Consumer Price Index has risen by 4 percent. How does the trustee invest?

If the trustee invests solely in bonds to maximize income to Mom, Junior will see his legacy lost to inflation, as the principal fails to grow at all. Junior's lawyers may suggest he sue to collect the difference from the trustee. If the trustee invests primarily in equities, Mom's income may be reduced to a pittance, hardly what Dad had in mind. In this case, the "income only" trust has failed to meet the needs of any of the beneficiaries, and also puts the trustee at risk.

The problem is twofold. First, investment decisions become driven by the need for current distributions, rather than by what makes sense for the trust as a whole over the long term. Second, the interests of life tenant and remainderman are at odds, pitting (in this case) mother against son. What is needed is a way to satisfy Mom's cash-flow needs without being limited to some narrow notion of "income."

So how is "income" defined? Under traditional notions, embodied in the 1931 version of the Uniform Principal and Income Act adopted in Tennessee, only dividends, interest, rent, royalties, and the like, were classified as income. Capital gains were allocated to principal. This flowed naturally from our agrarian society, where land was the primary asset, and its rent or use was the only available benefit for the life estate holder.

The first wave of revolution occurred during and after the Depression. Income from many trusts declined, and the assets available for investment became more liquid and more varied. Accordingly, it became more common for the trust document to allow the trustee to invade principal. In practice, however, trustees are reluctant to touch principal, perhaps because of psychological resistance, perceived administrative difficulty in justifying such action to remaindermen, or fear of opening a

permanent floodgate.

With today's dazzling array of available investments, the second wave of revolution has come, this time by statute. In a paradigm shift as significant to trusts as Copernicus's heliocentrism, the center of the trust is no longer the income, but the total return on investments.

First, Tennessee, like most other states, has adopted the Prudent Investor Rule, in Tenn. Code Ann. §35-3-117, enacted in 1989. The trustee is allowed to focus on the investment portfolio as a whole, rather than each single investment, freeing the trustee to invest for "total return." It matters not whether the return comes from income, dividends, rents, capital gains, or just plain appreciation.

Second, and more importantly, Tennessee has adopted the 1997 version of the Uniform Principal and Income Act, Tenn. Code Ann. §35-6-101, et seq., effective July 1, 2000, applicable to existing as well as new trusts. Although the Act defines "income" in a general way, Tenn. Code Ann. §35-6-104 gives the trustee broad power to "adjust" between principal and income. Income can be re-characterized as principal, or vice versa, in the trustee's discretion, if the usual characterizations would be inequitable, and if certain procedural requirements are met. Thus, many Tennessee trusts have been transformed into a radical new creature: the "total return" trust.

In other words, effective immediately, not only may a trustee invest for overall long-term performance, regardless of the income beneficiary's current cash-flow needs, in many cases a trustee should do so for the benefit of that very same beneficiary, as well as for the benefit of the ultimate remainder beneficiaries. If the "income," traditionally defined, is insufficient, then some of the unrealized capital gain can be recognized and paid out to make up for what the "income" could have been had it all been invested in bonds. The result is lower income taxation to the income beneficiary, by reporting capital gain instead of ordinary income, plus more assets left in the trust at the end of the year. The trustee is happy, all beneficiaries benefit, and best of all, the original grantor of the trust is praised, not vilified, for having set his affairs in order with a trust.

To confirm that the revolution is complete even at the federal level, the IRS has issued proposed regulations [Reg-106513-00] accommodating all these state law changes, ensuring the marital deduction, GST grandfathering, etc., when trusts make the switch to "total return." Viva La Revolucion!

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