Got Microsoft? Trustees should expect a fight

By Dan W. Holbrook

Income or principal? Trustees must characterize every receipt as one or the other, or some combination. Beneficiaries may worry that their financial well-being could be drastically affected if a trustee failed to characterize trust receipts accurately. Trustees may worry that they are at risk as well if beneficiaries' differing interests make them question the trustees' judgment. The general rules for allocating between income and principal, contained in Tennessee's Uniform Principal and Income Act (UPAIA), *Tenn. Code Ann.* §35-6-101 *et seq*., enacted in 2000, can sometimes surprise, however. For example, an IRA paid to a trust upon the account owner's death may be entirely taxable income for tax purposes but characterized entirely as principal for trust accounting purposes.

Many trustees were recently confronted with a major UPAIA event, whether they were aware of it or not. On Dec. 2, 2004, Microsoft paid a special dividend of $3 per share. Since the company had over 10 billion shares outstanding, the dividend amounted to about $32 billion, the largest single amount of capital ever paid out to investors anywhere any time. $3 per share represents about 11 percent of the $27 stock price on the payment date and about 35 percent of the roughly $92 billion of gross assets of the corporation.

Trustees and their income beneficiaries probably delighted in the extra cash flow, easily assuming that the net effect was a conversion of principal to income. But was it? There are competing authorities.

Argument for principal. *Tenn. Code Ann.* §35-6-401 contains rules for characterizing trust receipts from entities (corporation, partnership, etc.) as either income or principal, assuming the trust instrument doesn't specify (few do). Under paragraph (b), the general rule is that money received from an entity should be allocated to income. Under paragraph (c), there are exceptions that require allocation to principal instead, including money received in a total or partial liquidation of the entity. A partial liquidation occurs, says paragraph (d)(2), when "the total amount of money and property received in a distribution … is greater than 20 percent of the entity's gross assets."

Whoops. The Microsoft special dividend was about 35% of the entity's gross assets. The logical interpretation of the statute would be that all of that dividend should be treated as a partial liquidation and allocated to principal. Sorry, income beneficiaries of trusts, you may not be entitled to any of that special dividend.

The Official Comments to the UPAIA clarify as follows: "If a distribution exceeds 20 percent of the entity's gross assets, the entire distribution is a partial liquidation under subsection (d)(2)." Notice the focus in the official comments on the word "distribution" rather than the statutory word "received."

Argument for income. On the same day as the Microsoft dividend, Dec. 2, 2004, a three-judge California Court of Appeals unanimously held in a virtually identical fact situation, based on the identical California UPAIA, that the word "received" in the statute requires looking at the amount received by that one single trust receiving the dividend, not the entire amount being distributed by the entity. In other words, there is no "partial liquidation" under the UPAIA unless one trust alone receives more than 20 percent of the entity's gross assets. *Estate of Thomas*, 124 Cal.App.4th 711, 21 Cal.Rptr.3rd 741 (2004). This case requires that the Microsoft dividend be treated as income. Although this result seems patently absurd, the court went to considerable lengths to justify its conclusion. I understand a petition to the California Supreme Court has been filed, but statistically there is only a relatively small chance of both certiorari and reversal.

Like all uniform laws, UPAIA directs that it should be construed to be

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as consistent as possible with other states adopting it. Accordingly, the *Thomas* case from California may carry significant precedential weight in Tennessee. There appear to be no other cases construing the statute.

It may be significant that the legislature of the state of Washington, home of Microsoft and of many of its biggest shareholders, modified the UPAIA by deleting the word "received" in paragraph (d)(2) and substituting the word "distributed," thus making the *Thomas* decision clearly inapplicable in that state alone.

Tennessee Law. This leaves Tennessee trustees with a dilemma. What to do?

Trustees who have already paid out the dividend as income can point to the *Thomas* case if questioned by unhappy remainder beneficiaries. Of course, lack of contemporaneous records of the trustees' deliberations as to how to characterize the receipt may still leave Trustees feeling exposed.

Trustees who retained the Microsoft dividend as principal, or who are still deciding how to treat it, have five choices:

(1) Rely on the plain language of the Tennessee statute, including its Official Comments. Add the dividend to principal. Consider explaining the dilemma to the income beneficiaries and seeking a release.

(2) Rely on *Thomas* as the sole precedent, assuming that Tennessee and all other states with the same version of the UPAIA would be likely to concur. Pay it out as income. Consider explaining the dilemma to the remainder beneficiaries and seeking a release.

(3) Hold the amount in suspense, until there is reasonable certainty in Tennessee. Such certainty might arise from a definitive opinion from the California Supreme Court; or better yet from a case or Attorney General Opinion in Tennessee; or best of all from the Tennessee legislature's retroactive adoption of Washington state's amendment to the uniform act. Of course, reasonable certainty may never arrive. Consider lobbying your state legislator in any event so that similar situations will not be a future problem.

(4) With an "income-only" trust, exercise the Trustee's power to adjust under *Tenn. Code Ann.* §35-6-104, to recharacterize all or any portion of income as principal, or vice versa, to strike the optimum balance among all of the beneficiaries of the trust.[1] That is, use the flexibility within UPAIA itself to resolve any uncertainties UPAIA is causing.

(5) Make your trust the test case and seek a ruling in Tennessee. Or become the defendant when one of the trust beneficiaries sues. Be sure you let the rest of us know the outcome.

Note

1. See the author's column on the trustee's power to adjust under the UPAIA in Holbrook, "Total Return Trusts Come to Tennessee," 37 *Tenn. Bar J.* 33, December 2001.

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