Fiduciary's Power to Adjust - Update

Take-Away: A trustee can exercise a power to adjust and treat trust principal as trust income in certain situations under Michigan's version of the Uniform Fiduciary Principal and Income Act. It may soon be possible, if a pending bill is passed, for a trustee also have the power to convert a 'pay income' trust distribution standard to a unitrust distribution standard, thus simplifying the trust's administration.

Background: In 2004 Michigan adopted its version of the Uniform Principal and Income Act, which is now called the Uniform *Fiduciary* Principal and Income Act. When the Act was adopted in Michigan, one option was omitted from Michigan's version of the Uniform Act. Michigan adopted the version that gives to a fiduciary the authority to *adjust* between principal and income when the income generated by the estate or trust is inadequate to meet the income distribution needs of the beneficiaries. Another option under the Act that Michigan did *not* adopt was the authority given to a fiduciary to permanently convert a 'pay all income' distribution standard to a unitrust distribution standard.

Conversion Bill: There is currently a bill before the Michigan Legislature that would give a fiduciary the power under the Act to permanently convert a 'pay all income' distribution standard to a unitrust distribution standard where a set percentage of trust or estate assets is distributed to the 'income' beneficiary each year in satisfaction of the beneficiary's right to receive income.

Power to Adjust: MCL 555.504(1) is the current provision of the Uniform Act that gives the fiduciary the power to *adjust:*

*A fiduciary may adjust between principal and income to the extent the fiduciary considers necessary if the fiduciary invests and manages trust or estate assets as a prudent investor, the terms of the trust or will describe the amount that may or must be distributed to a beneficiary by referring to the trust or estate's income.*

Factors: The factors that a fiduciary must consider when exercising the power to *adjust* include: (i) the purpose and expected duration of the trust; (ii) the settlor's intent; (iii) the beneficiaries' identity and circumstances; (iv) the needs for liquidity, regularity of income and preservation and appreciation of capital; (v) the nature and character of the assets held in trust, and whether an asset is used by the trustee; (vi) the net amount allocated to income under the Act and the increase or decrease in the value of trust assets; (vii) whether the terms of the trust expressly permit or prohibit the trustee from 'invading' trust principal or accumulating income; (viii) whether the trustee has previously exercised the power to *adjust;* (ix) the actual and anticipated effect of economic conditions; and (x) the anticipated tax consequences of an *adjustment.*

Thus, there are several factors that must be considered either to implement, or restrict, the fiduciary's power to adjust. The key point is that each time the fiduciary exercises the power to adjust it must document that decision, the reasons why, and how the amount of principal to be distributed to the 'income' beneficiary was determined. In other words, the trustee must do a lot of work each year just in making the decision to 'invade' principal and classify it as income, and the fiduciary must document its decision-making process each year that this power to *adjust* is exercised. In some instances, the trustee cannot even exercise the power to adjust if the trust instrument prohibits any power to adjust.

Duty of Impartiality: A power to *adjust* usually will implicate a trustees duty of impartiality to all beneficiaries, along with its duty to invest trust assets prudently under the Prudent Investor Act. [see MCL 700.7803 for a trustee's *duty of impartiality.*] These fiduciary duties can sometimes conflict. One example is if the trustee's prudent investments might generate more principal growth at the expense of immediate income, while yet another investment strategy would favor current dividends over long-term principal growth. An investment strategy with an emphasis on growth-oriented stock with minimal dividends might be considered prudent by the trustee, yet it would run afoul of the trustee's duty of impartiality regarding all trust beneficiaries (current *and* remainder.) This duty of impartiality and the trustee's decision to exercise its power to adjust under the Uniform Act can often lead to litigation, which was the case in a recent Massachusetts Supreme Judicial Court decision.

*In the Matter of The Trusts Under the Will of Helyn W. Kline (Docket No. SJS-13579, November 5, 2024)*

Facts: Testamentary trusts were created under a Will. The trustees were required to make income distributions to Levy, and were permitted to make principal distributions to Levy only in emergency situations, and only under the most extraordinary circumstances. Levy served as a trustee with a non-beneficiary co-trustee, Kline. Levy's children were the remainder beneficiaries of the trusts. Kline pursued a 'total growth' investment strategy for the trust's assets, which resulted in significant growth of trust principal, but 'trust income had not kept pace.' Kline thus exercised his power to adjust under Massachusetts' version of the Uniform Act, by moving some items of trust principal to trust income. Kline testified that he considered Levy's cost of living, her other income sources, and the relevant factors set forth in the Massachusetts' statute, including the testator's intent. After exercising this power to adjust, one of the trust beneficiaries, Levy's son, sued the co-trustees claiming an improper distribution of trust principal to Levy in excess of the trust's net income.

Trial Court: The probate judge granted the co-trustees' motion for summary judgement on the basis that the Uniform Act authorized the adjustment. Levy's son filed an appeal of that decision.

Supreme Judicial Court: The appellate court upheld the grant of summary judgment in favor of the co-trustees. Several findings were made by the Court:

'Emergency' Does not Limit Power to *Adjust:* The terms of the trust did not preclude Kline form adjusting between principal and income. Under the Massachusetts version of the Uniform Act, a trustee can adjust between principal and income if three prerequisites are met: (i) the trustee must invest and manage the trust assets as a prudent investor; (ii)the terms of the trust must describe the amount that may or must be distributed to a beneficiary by referring to trust income; and (iii) the trust instrument did not contain a 'different provision' that barred the exercise of the power to adjust. Critical was the Court held that the provision that limited principal distributions to Levy to extraordinary emergency situations was "not a different provision barring the power to adjust."

Consequently, this directive to pay principal only in emergency situations did not preclude adjustments between principal and income, distinguishing the Act's *adjustments* as different from distributions of principal to a trust beneficiary.

Substantial Deference: The Court also found that Kline, as the non-beneficiary co-trustee, did not abuse his discretion to exercise the power to *adjust.* The Uniform Act requires a trustee to consider all factors relevant to the trust and its beneficiaries. The Act includes nine nonexclusive factors that could be relevant to the trustee's determination to exercise the power to *adjust.* As a result, the Court decided to give substantial deference to the trustee's decision to *adjust,* and said it would only review that decision if it appeared the co-trustee abused his discretion, which Levy's son failed to allege.

Conclusion: A one-time conversion of an estate or trust to a *unitrust* distribution standard would be a power that would be welcome by many fiduciaries, especially in low-income market environments, or where there exists conflict between current and remainder beneficiaries.