Unitrust Conversions on the Horizon?

Take-Away: Michigan trustees may soon have the authority to convert an *income* trust to a *unitrust.*

Background: The Michigan Legislature is currently looking at an amendment to the Uniform Fiduciary Income and Principal Act. [MCL 555.501 et. seq.] Unlike some states, Michigan's version of this Act currently does not authorize the trustee of a trust to unilaterally convert an *income*-only trust to a unitrust.

Unitrust: If an irrevocable trust pays '*income*' to a beneficiary, some versions of the Uniform Act authorize the trustee to convert the irrevocable trust from an '*income-only*' trust to a '*unitrust'* that pays a fixed percent of the trust's asset value to the beneficiary, regardless of the amount of *'income'* the trust generates. Unlike an '*income-only*' trust that distributes fluctuating dividends, interest, rents, and royalties and any other income net of expenses to the trust beneficiary, a *unitrust* distributes a stable and reliable percentage of the trust's value to the beneficiary at regular intervals.

Perceived Advantages of a Unitrust: The conversion of an *income* trust to a *unitrust* is helpful when:

Compliance with Prudent Investor Rule: The trustee faces the challenges of complying with the Prudent Investor Rule [MCL 700.1501-700.1512.] that encourages investments for total return, when the trust instrument expressly requires or excludes certain investments.

Total Return Investing: A unitrust conversion will allow the trustee to pursue a total investment return approach without the fear of being accused of favoring the trust's income beneficiary over its remainder beneficiaries. Thus, the income beneficiary and the remainder trust beneficiaries share in the same goal of increasing the portfolio's value and there is less strain on their respective positions in the trust.

Predictable Cash-Flows to the Beneficiary: A unitrust provides for a reasonable income/cash flow to the *income-only* beneficiary when income yields on stocks and bonds may be historically low.

Beneficiary's Budgeting: A unitrust enables the trust's *income-only* beneficiary to better budget, since the unitrust distribution amount for a calendar year will be known early into that year, if the 'snapshot' value of the trust's assets is taken as of December 31 of the prior calendar year. A possible corollary benefit is that if the beneficiary is better able to budget anticipated distributions from the trust with a unitrust distribution amount, there might be fewer reasons for the income beneficiary to ask the trustee to make discretionary distributions of trust principal for that beneficiary's health, support, and education.

GST: Converting to a unitrust will not affect an income trust's grandfathered generation skipping transfer tax (GST) exempt status. [Regulation 26.2601-1(b)(4)(i). See Regulation 26.2601-1(b)(4)(i)(E) for an example.]

Gift Tax: Nor will the *income-only* beneficiaries of the trust who consent to the trust's conversion to a unitrust be treated as having made a taxable gift under IRC 2501. [Private Letter Ruling 200747017.]

Potential Disadvantages of a Unitrust: While multiplying a fixed percentage against a trust's asset value sounds like a simple way to identify the distributable amount from the trust, there are some potential disadvantages to using a unitrust.

Beneficiary's Needs May Change: While the annual percentage rate is fixed, the beneficiary's needs may change over time. This disadvantage can be solved by giving the trustee limited discretion to pay more than the percentage amount in some years or situations;

Asset Values Difficult to Determine: If the trustee holds some assets like real estate, closely held business interests, alternative investments, private equity, etc. it will be difficult for the trustee to obtain at the end of each calendar year a fair market value for those assets to determine the unitrust distribution amount for the following year.

For real estate, sometimes the need for a qualified appraisal each year can be avoided by the trustee using a formula like [2 times State Equalized Value + 3% = Fair Market Value] for a couple of years to approximate fair market value of real estate, with the need for a qualified appraisal limited to every 4th or 5th year. Similarly, formulae can be used for private equity or closely held business interests. However, in the end, using those formulae is nothing more than using educated guesses at fair market value, which means that following a unitrust distribution formula may ultimately lead to overpaying (or underpaying) the 'income' beneficiary.

Creditors: Converting an *income-only* trust to a unitrust, seems to be the equivalent to the current beneficiary holding a power of withdrawal, which is akin to a general power of appointment over the trust. The question then is whether a power of withdrawal (of the unitrust amount) is an interest that could be seized by the beneficiary's judgment creditor, or whether, if perceived by the IRS as a power of withdrawal, will unnecessarily cause part of the trust's assets (the unitrust percentage) to be included in the trust beneficiary's gross estate for federal estate tax purposes.

Power to Adjust: The current version of Michigan's Uniform Fiduciary Principal and Income Act does give the trustee of an *income* trust the authority to adjust and classify trust principal as trust *income* for purposes of distributing trust *income.* [MCL 555.504.] However, for a trustee to annually exercise this power to adjust, it must consider *all factors relevant to the trust or estate and its beneficiaries,* leaving it up to the trustee to figure out if it has identified *all factors.* The statute also sets out several situations, or limitations, where the trustee may not exercise the power to adjust and treat trust principal as trust income.

Thus, the key difference between a power to adjust and a one-time unitrust conversion is that each year the trustee must decide whether to exercise its power of adjustment, it must then document that decision, and it must identify the factors that it will consider and rely upon in exercising its adjustment power, which burden it must annually accept and document, possibly leading to higher fiduciary fees.

Conclusion: Giving a trustee the authority to convert an *income-only* trust to a unitrust provides much greater flexibility to the trustee in its efficient administration of the trust. Not every trust will be converted to a unitrust, depending on the trust's terms and assets, but it will provide the trustee with one more tool to consider in addressing the needs of all trust beneficiaries.