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Total Return Trusts Give Trustees Flexibility in Ever-changing Markets

By [Louis S. Harrison, Erica E. Lord and Senator Kirk W. Dillard](#)

The Total Return Trust Act permits trustees to invest prudently while spreading the benefits of asset appreciation to both remainder and income beneficiaries. This article discusses its most important provisions.

On August 22, 2002, former Gov. George Ryan signed a measure into law that significantly changed the landscape of trust administration in Illinois. PA 92-0838 (the "Act" or "Total Return Trust Act") permits a trustee, a beneficiary, or a court petitioned by either party to convert certain trusts into so-called "total return trusts." In general, a total return trust allows an income beneficiary to receive a fixed, annual unitrust distribution, rather than the actual dividends and interest produced by the trust principal.

Sponsored by Senator Dillard¹ and Representative Beaubien,² the Act provides an alternative for trust fiduciaries who, when faced with the duty to invest prudently and impartially, have previously found themselves balancing the competing interests of remainder and income beneficiaries. That balancing often led to disputes and even lawsuits when income beneficiaries and remainder beneficiaries challenged the trustee's investment strategy.

For example, if the trust's corpus contained primarily growth assets that appreciated tremendously yet produced no interest or dividends, income beneficiaries complained that the trustee was not investing prudently. Some income beneficiaries asserted that the trustee had a responsibility to equalize the disproportionate growth of the trust by investing a greater percentage of the trust portfolio in fixed income assets. This conflict intensified during the market growth of the late 1990s, when beneficiaries witnessed

tremendous growth of their trust funds due to capital appreciation but income beneficiaries could not tap this increased wealth without the trustees selling a large portion of the portfolio to convert that capital into income-producing assets.

Trustees also faced discord from remainder beneficiaries who resisted reallocation because of the tremendous potential for capital appreciation in the late 1990s equity markets and the significant capital gains taxes associated with conversion. The Total Return Trust Act provides middle ground for a trustee seeking to fulfill his or her duty to invest prudently while at the same time spreading the benefits of appreciation to both remainder and income beneficiaries.

I. Balancing the Tension between Remainder and Income Beneficiaries

The Total Return Trust Act provides a means by which a trustee can balance the inherent tension between income beneficiaries, who generally prefer that a trustee invest in income producing assets, and remainder beneficiaries, who more often prefer investments that will create long-term capital appreciation that the remainder beneficiary will recognize at a later time. The Act does not alter state law definitions of income and principal.

Under the Illinois Principal and Income Act, income is defined as "the return in money or property derived from the use of principal," including items such as rent, interest, and dividends.³ While the Act does not change the definition of income, it does affect the characterization of income by creating a "distribution amount," which is distributable to the income beneficiary whether or not the amount is derived from traditional items of income or principal.

Traditionally, the Prudent Investor Rule⁴ under Illinois law requires a trustee to invest and manage trust assets as a prudent investor would and imposes a duty of impartiality on the trustee to invest for the benefit of both the current income beneficiaries and the remainder beneficiaries.⁵ However, this investment strategy can create tension between remainder and income beneficiaries, especially when the terms of a trust do not provide for discretionary principal distributions to the income beneficiary.

For example, a spouse might structure a QTIP marital trust in this fashion to restrict the surviving spouse's right to principal or where an income interest seemed adequate when the estate was planned. Where a trustee lacks discretionary distribution powers to share capital appreciation with the income beneficiary, trustees have previously been relegated to reallocating trust assets in an attempt to alleviate disparities between appreciating capital growth assets and fixed income assets.

In scenarios such as these, the Total Return Trust Act provides trustees with another way to balance the interests of beneficiaries while allowing the trustee to invest the trust assets prudently for maximum return and without regard to whether the investments represent income or principal under state law.

To illustrate the conflict between income and remainder beneficiaries, consider a trust where the trustee invests 50 percent of the trust assets in equities that produce minimal dividends. In this scenario, only half of the trust assets produce income in the traditional sense of dividends and interest. However, in a market where growth equities provide a higher overall rate of return than fixed income investments, a trustee might prefer to invest in growth equities to increase the overall value of the trust's assets. Nevertheless, some income beneficiaries resisted growth equities, arguing that the purposes of the trust are frustrated when a trustee invests 50 percent or more of the trust's assets in investments that do not

produce income.

As one possible solution, a trustee can periodically exchange non-income producing investments and reallocate a portion of the amount realized into income producing investments, thus spreading some capital appreciation to the income beneficiary. However, continual reallocations create capital gains tax which diminish the trust assets and create a disincentive for the trustee to reallocate trust investments. Moreover, reallocation runs contrary to the investment philosophy shared by some trustees, who instead favor a relatively passive investment strategy (e.g. investing in indexed equity portfolios and avoiding the recurring costs associated with frequent trading) over reallocation.

II. The Unitrust Arrangement

In contrast to reallocating investments, the Total Return Trust Act creates a unitrust distribution arrangement, which may be preferable for both the income and remainder beneficiary. For example, [Figure 1](#) illustrates the disparity between a unitrust arrangement and a traditional trust administered by converting growth assets into income through reallocation.

In this example, both trusts contain assets valued at \$2 million at origination, and both trusts invest in fixed income investments that earn a rate of return averaging 4 percent annually. The trustee of the total return trust invests the full \$2 million of the trust corpus in fixed income investments and will distribute 4 percent, or \$80,000, at the end of the first year. The unitrust distribution will grow to \$82,355 by year 10.⁴

In contrast, a trustee using the reallocation method to invest prudently and impartially for both the income and remainder beneficiaries might follow an investment philosophy that invests 50 percent of the trust assets in income producing assets, and the remaining 50 percent in equities that produce capital appreciation. At the end of the first year, this trustee will distribute 4 percent, or \$40,000, to the income beneficiary.⁷

Assuming that the equity investments grow annually at a rate of 6 percent, the income producing investments will comprise only 43 percent of the trust assets at the end of year five. The remaining 57 percent of the trust assets that do not produce income will continue to grow for the benefit of the remainder beneficiary.

To correct for this disparity, the trustee must readjust the portfolio back to the 50/50 investment ratio to balance the disproportionate growth of the trust assets. To reallocate, the trustee sells a portion of the growth equities at the end of year five that, in turn, creates capital gains taxes. After paying capital gains the trustee invests the net amount realized into fixed income investments, and 50 percent of the trust remains invested in equities and growth assets.

Using this reallocation process, at the end of 10 years, the income beneficiary would receive income totaling only \$426,043, compared to the \$825,236 distribution that a beneficiary could have received from a total return trust with a distribution percentage of 4 percent.⁸ Even in the long run, at the end of 30 years, the income beneficiary of the traditional trust would receive approximately \$1.75 million of income compared to the \$2.4 million that an income beneficiary could receive in 30 years from a total return trust.⁹

The same disparity exists between remainder beneficiaries, as [Figure 2](#) shows. Assuming that the equity

investments in the traditional trust yield 6 percent annually, at the end of 30 years, the remainder beneficiary's interest in the total return trust would be approximately \$3.5 million, compared to a \$2.7 million remainder interest when the trustee uses the reallocation method.

Under a traditional trust arrangement using the reallocation method, the beneficiary can only benefit from growth assets where (1) the market produces tremendous growth over sustained periods, or (2) the income beneficiary receives income distributions over an extremely long time horizon. Moreover, the reallocation of assets also costs the remainder beneficiary a substantial portion of his or her interest each time that capital gains are realized. Hence, the practice of reallocation created enormous tension between (1) the trustee's desire to adhere to a traditional prudent investor philosophy; (2) the income beneficiary's desire to receive an adequate and steady stream of income from the trust; and (3) the remainder beneficiary's desire to realize long-term capital growth.

III. Conversion to a Total Return Trust

Public Act 92-0838 amends section five of the Illinois Trusts and Trustees Act, 760 ILCS 5/1 et seq by adding section 5/5.3. Section 5/5.3 allows a trust to be converted into a "total return trust" by a trustee, by a beneficiary, or by a court where either party petitions for conversion. Once converted, the beneficiary receives a fixed unitrust distribution amount calculated as a percentage of the fair market value of the trust's assets, rather than a traditional income distribution in the form of interest and dividends. The Act contains certain restrictions and limitations on the types of trusts that can be converted, but generally allows many types of trusts to be converted to total return trusts.

A trust can be converted by any of three alternative means: by the trustee acting alone, by an agreement between the beneficiary and the trustee, or by a court acting pursuant to the petition of either the trustee or a beneficiary.

A. Conversion by a Trustee Acting Alone

The Act defines a total return trust as one in which the trustee may invest trust assets to seek the highest total return.¹⁰ This definition represents a departure, albeit a subtle one, from the prior prudent investor standard. The prudent investor rule requires a trustee to diversify the trust portfolio, to spread risk across different asset classes, and to invest impartially for the benefit of both the income and remainder beneficiaries by pursuing an investment strategy consistent with both the reasonable production of income and the safety of capital.¹¹

The subtle difference between this standard and the total return trust standard is that arguably, the trustee of a total return trust is free to allocate a greater portion of the portfolio to investments that do not produce current income without violating the prudent investor rule. With this freedom, the trustee can invest trust assets to achieve greater growth that, assuming growth is achievable over the long term, creates benefit for both the remainder and income beneficiary.

A trustee who acts alone to convert a trust without reaching an agreement with the beneficiaries must comply with certain procedural requirements. If the trustee complies with these requirements and converts the trust, the income beneficiary is entitled to receive a unitrust distribution amount fixed at 4 percent.

Existing trust must distribute income to a beneficiary. Not every trust qualifies for conversion to a

total return trust. The Act specifies that a trustee can only convert where the "trust describes the amount that may or must be distributed to a beneficiary by referring to the trust's income."¹² In other words, the terms of the trust must provide for discretionary or mandatory payment of income to a beneficiary. For example, both a QTIP trust and an IRC § 2056(b)(5) life estate with power of appointment trust qualify for conversion because the Internal Revenue Code requires these trusts, by definition, to distribute all income to the beneficiary for life.

Conversion would better effectuate trust purposes. The trustee must determine that conversion to a total return trust would allow "the trustee to better carry out the purposes of the trust."¹³ This determination requires that a trustee exercise discretion and judgment, yet the statute does not define exactly what guidelines the trustee should rely on to reach this conclusion.

For example, consider a QTIP marital trust established by a grantor with the intent to provide his or her surviving spouse with adequate support for the remainder of the surviving spouse's life. Under current market conditions, assume that the trust's assets do not produce sufficient income to support the surviving spouse's needs. In this scenario, a trustee might determine that conversion would effectuate the grantor's purpose and pursue conversion. Nonetheless, this is an ambiguous requirement because few trust instruments explicitly delineate the grantor's intent.

Conversion serves the beneficiaries' best interests. Before converting to a total return trust, the trustee must determine that conversion will serve the best interests of both the income beneficiary and the remainder beneficiary.¹⁴ Again, the Act does not define the best interests standard, nor does it provide guidelines for a trustee making this determination.

However, the best interests standard is probably a low hurdle for the trustee to clear where a guaranteed 4 percent unitrust distribution would provide the income beneficiary with a higher return than would otherwise be possible and would also generate greater capital appreciation for the remainder beneficiary. Notwithstanding this fact, the trustee probably could not act alone to convert a trust where conversion would not at least arguably serve the best interests of both beneficiaries.

Manage trust assets as a total return trust. The trustee must agree to manage the assets to generate total return on the investments and must make distributions according to the provisions of the Total Return Trust Act without regard for whether the returns are generated from traditional items of income or from capital appreciation.¹⁵

For example, if a trustee converts a traditional trust to a total return trust and subsequently invests the assets to produce the greatest overall return, the trustee cannot selectively distribute traditional items of income to the beneficiary in lieu of the unitrust distribution amount in years where items of interest and dividends exceed the 4 percent unitrust amount. Once the trust has been converted, the trustee must comply with applicable provisions of the Act.

Provide notice. After deciding to convert to a total return trust, the trustee must send written notice of its decision to all legally competent beneficiaries who (1) currently receive or are eligible to receive income from the trust and (2) would receive or be eligible to receive a distribution of principal or income if the interests of the current beneficiaries ended. The notice must specify a prospective date for conversion and must include a copy of the Total Return Trust Act.¹⁶

Ensure competent trust beneficiaries. A trustee cannot act alone to convert to a total return trust unless the trust has at least one legally competent income beneficiary and one legally competent remainder beneficiary.¹⁷

Ensure no beneficiary objects. The Act provides a 60-day window in which beneficiaries can object to the conversion in writing. A beneficiary's objection must be delivered to the trustee within a 60-day period which begins to run on the date the trustee sends notice.¹⁸ Although a beneficiary's objection may prevent the trustee from acting alone to convert the trust, a trustee could still petition a court to order conversion (see subsection "C" below).

Obtain acknowledgements. The trustee must obtain signed acknowledgments, confirming that the trustee has provided notice to each beneficiary who is entitled to receive notice (see "[p]rovide notice" above).¹⁹

Once all of the procedural requirements have been met, the trustee can administer the trust as a total return trust. The Act provides guidelines for doing so and grants the trustee discretion to make numerous administrative decisions, including selecting the effective date of conversion, determining the manner in which distributions are paid, and making decisions about valuation of the trust assets.²⁰

B. Conversion by Agreement

Alternatively, the trustee and all primary beneficiaries²¹ can reach an agreement to convert a trust to a total return trust. The agreement can provide for a minimum unitrust distribution of 3 percent and a maximum of 5 percent. Thus, a beneficiary seeking a distribution amount greater than 4 percent has some incentive to object to conversion in the hope of negotiating with the trustee for a greater distribution. At the opposite end of the spectrum, conversion by agreement may be an attractive option where even a 3 percent distribution amount would increase the income beneficiary's rate of return and where the parties can amicably reach an agreement.

The agreement may, but need not, include any of the remedies provided in section 5/5.3(g) of the Act which, for example, include: (1) the right of either a trustee or a beneficiary to bring an action to reconvert the trust from a total return trust back to the trust's original income distribution standards; (2) the right to bring a court proceeding to obtain a court order to adjust the distribution percentage; and (3) the right to bring a court proceeding to direct the distribution of traditional net income, where the traditional items of income exceed the total return trust distribution amount and where all income must be distributed to preserve a tax benefit.

C. Conversion or Reconversion by Court

Both a trustee and a beneficiary can seek conversion to or reconversion from a total return trust by petitioning a court. In either case, a court must order conversion if the conversion (or reconversion) would (1) better carry out the purposes of the trust, and (2) serve the best interests of the beneficiaries.

Although a trustee alone could ordinarily take action to convert a trust without court intervention, trustee conversion may not be possible if a beneficiary timely objects to or refuses to amicably agree to conversion. When a trustee petitions the court to convert or reconvert a trust, the Act allows, but does not

require, a trustee to present his or her opinions and the reasons in support or opposition of the conversion, as well as any other pertinent information relating to the conversion.

A beneficiary might petition a court for intervention where the beneficiary has requested conversion and the trustee has declined the request. For example, under the terms of the Act, if a beneficiary requests that the trustee convert (or reconvert) a trust or adjust the unitrust distribution standard, the trustee must respond within six months. Where a trustee declines the beneficiary's request or fails to act within six months, the beneficiary may petition the court to convert or adjust the distribution amount.²²

As mentioned above, the statute does not provide trustees with guidelines or standards for determining when conversion "would better carry out the purposes of the trust." Although some trust documents articulate the grantor's purposes for establishing the trust, a trustee may have to make this determination alone, based on the circumstances and relationships of the parties.

For instance, the trustee may be able to establish that the grantor intended to provide a steady stream of income to his or her surviving spouse when the grantor's will also transferred all income-producing property to the surviving spouse for life. Likewise, a trustee might be able to conclude that the grantor intended to provide support for a grandchild where the grantor established a generational skipping trust and named his or her only grandchild as beneficiary.

The statute also does not define the best interests standard, nor does it provide guidelines for a trustee making such a determination. However, a trustee could probably establish that conversion would serve the best interests of the beneficiaries where the trust assets would create greater returns for the beneficiaries. The best interests standard might also be met where conversion would allow a trustee to direct trust funds into investments that would provide greater stability or diversification of the trust's assets.

In short, the trustee must be able to articulate a reason for conversion that at least arguably will enhance the interests or the welfare of the beneficiaries and carry out the purpose of the trust.

IV. Trustee Liability

Several provisions of the Act safeguard trustees from potential liability for converting or failing to convert to a total return trust. The Act shields a trustee who acts reasonably and in good faith from potential claims by beneficiaries. Section 5/5.3(c)(4) provides that a trustee's actions to petition the court for conversion or reconversion "shall not be deemed improper or inconsistent with the trustee's duty of impartiality unless the court finds from all the evidence that the trustee acted in bad faith."²³ Section 5/5. (k) provides that "[a] trustee who reasonably and in good faith takes or omits to take any action under this Section is not liable to any person interested in the trust."

As an additional safeguard from liability, the Act provides that a trustee has neither a duty to inform a beneficiary of the right to seek conversion by petitioning the court nor a duty to conduct review to determine whether to convert (or reconvert) a total return trust, unless a legally competent beneficiary submits a written request that the trustee make such an inquiry.²⁴

Nevertheless, a beneficiary who would have benefited from conversion might still attempt to sue a trustee who failed to convert, and an income beneficiary who resisted conversion in favor of the security of fixed

income investments might attempt to sue a trustee for converting. If a beneficiary brings such a claim, section 5.3(k) protects trustees by providing that the beneficiary's sole remedy is to seek a court order directing the trustee to (1) convert or reconvert the trust, (2) change the distribution percentage, or (3) order any administrative procedure that the court determines necessary or helpful for the proper functioning of the trust. Furthermore, section 5/5.3(k) specifically creates a presumption that the trustee acted reasonably and in good faith. Thus, the party challenging the trustee's action or omission bears the burden of proving that the trustee abused its discretion or acted in bad faith.

V. Post-Conversion Distributions

Once a trust has been converted to a total return trust, the trustee must eventually determine the distribution amount payable to the beneficiary. This amount is determined by applying a distribution percentage to the fair market value of the assets of the trust over the lesser of (1) the preceding three years or (2) the period during which the trust has been in existence.²⁵ The distribution percentage is established either (1) by the terms of the agreement between the beneficiaries and the trustee, (2) by court order, or (3) by the terms of the Act if the trustee acts alone to convert the trust.

For example, consider a trust that has existed for exactly three years. The trust's assets have had a net fair market value of \$1.25 million in year one, \$2.5 million in year two, and \$3.75 million in year three. Over these three calendar years, the net fair market value of the assets averages \$2.5 million. Assuming that the trustee acts alone to convert the trust, the income beneficiary is entitled to receive a fixed 4 percent distribution, which when multiplied against the average fair market value of the assets results in a distribution amount of \$100,000. Thus, although the distribution percentage is fixed, the distribution amount may vary from year to year depending on fluctuations in the market value of the trust portfolio.

VI. Administration, Allocations, and Restrictions

Under the terms of the Act, the trustee retains broad discretion over some aspects of administering the total return trust. In addition to traditional investment and management duties provided in the original trust document, the Act gives the trustee discretion to determine (1) the effective date of the conversion, (2) the manner of adjusting valuations to account for payments or contributions from the trust, (3) whether to make distributions in cash or in kind, and (4) whether to exclude an asset from the fair market value calculation of the trust's assets when no readily available market for it exists.

A. Allocations

The allocation provisions of the Act distinguish a total return trust from a traditional trust in several ways. Section 5/5.3(f)(1) of the Act provides that expenses, taxes, and other administrative charges should not be paid from the distribution amount, even if they ordinarily would have been deducted from the amount paid to the income beneficiary if the trust were not a total return trust. Thus, a trustee of a total return trust must allocate such expenses to corpus, rather than paying them from the unitrust distribution amount.

Additionally, section 5/5.3(f) establishes ordering rules for funding the distribution amount, specifying that it shall come first from net ordinary income, then from net realized short-term capital gains, then from net realized long-term capital gains, and then from assets in the trust principal for which there is a readily available market. Finally, any remaining portion of the distribution amount must be funded from remaining principal assets.

These ordering rules represent a departure from the distributable net income (DNI) rules contained in section 643 of the Internal Revenue Code (the "code"),²⁶ which ordinarily exclude capital gains from DNI to the extent they are allocated to corpus and not paid or distributed by the trust. Under current DNI rules gains from the sale or exchange of trust assets are taxable to the trust. In contrast, the ordering rules in the Total Return Trust Act allow the trustee to distribute capital gains to fulfill the unitrust distribution amount.

In February of 2001, the U.S. Treasury Department issued proposed regulations in an attempt to reconcile the provisions in section 643 with the growing number of state laws that allow total return trusts.²⁷ The department has not taken further action, but the proposed regulations signal the IRS' willingness to permit unitrust distributions from capital gains when a total return trust is established pursuant to state statute.

These regulations align the treatment of capital gains and DNI to conform with state total return trust law by providing that capital gains are includible in DNI to the extent that state or local law or the governing instrument allocates them to the trust corpus, yet allows a fiduciary to utilize such gains in determining the amount to distribute to the income beneficiary.²⁸ The regulations specifically bless total return trusts having a 3- to 5-percent unitrust distribution, and Proposed Treasury Regulation section 1.643(a)-1(e), example 9, provides guidance in applying the proposed regulations to Illinois total return trusts. The example contains ordering rules identical to the Illinois rules and permits the total return trust to include capital gains in distributable net income when the gains are allocated to the unitrust income distribution pursuant to the state's ordering rules.²⁹

The proposed regulations also permit total return trusts to qualify for the marital deduction, providing that the "all income" requirement is met for trusts that qualify as total return trusts under state law and that give "the spouse substantially that degree of beneficial enjoyment of the trust property that the principles of trust law accord to a...life beneficiary of a trust."³⁰

B. Restrictions

The Act also contains several important restrictions and tax limitations. For instance, where a trust claims an estate or gift tax marital deduction, the distributed "amount may not be less than the net income of the trust, determined without regard to the [total return trust provisions]."³¹ Thus, for example, if a QTIP trust generates income in the traditional sense of interest and dividends and the income exceeds the unitrust distribution amount, the trustee must pay out all the income to the beneficiary to receive the tax benefits of the unlimited marital deduction.³² This limitation also applies to trusts that were exempt in whole or in part from the generation-skipping transfer tax on August 22, 2002, when the Illinois legislature enacted the Total Return Trust Act.

The Act also provides that conversion to a total return trust does not affect provisions in the governing trust instrument that direct or authorize the trustee to distribute principal, fixed annuities, or a fixed percentage of the trust assets. Likewise, conversion does not affect provisions in the governing trust instrument that authorize a beneficiary to withdraw any of the trust principal. For example, conversion to total return trust does not prevent a surviving spouse from exercising power to appoint all or a part of the trust principal where he or she is a beneficiary of a marital trust. The Act merely changes the characterization of the income payable to the beneficiary under the provisions of the trust document.³³

One other notable limitation concerns trusts in which one of the beneficiaries also serves as a co-trustee. Where the conversion (or failure to convert) the trust would alter the trustee's beneficial interest, the trustee-beneficiary may not exercise the power to convert in his or her capacity as a trustee. However, this limitation does not preclude that trustee from petitioning the court for conversion in his or her capacity as a beneficiary.³⁴ In addition, if one or more co-trustees are not also beneficiaries of that trust, those co-trustees can act alone to convert the trust, so long as the trustee-beneficiary does not participate in the decision in his or her capacity as trustee.

This limitation also applies where a trustee-beneficiary participates in converting a trust and his or her participation alters the nature of the beneficial interests. An individual who is both a trustee and a beneficiary cannot initiate conversion as a trustee if it would cause anyone to be treated as the owner of part of the trust, or where conversion would cause a part of the trust to be included in any individual's gross estate. In those cases, the trustee-beneficiary may only act in his or her capacity as a beneficiary and, therefore, could not initiate conversion except by seeking a court order or reaching an agreement with the trustees to convert.

Finally, the grantor of a trust can always prevent conversion by including an express prohibition in the governing trust instrument, thus preventing a trustee, beneficiary, or court from converting the trust into a total return trust.

VII. Conversion Considerations

Because the Act requires a trustee to consider the best interests of all beneficiaries, as well as the grantor's purposes in establishing the trust, a total return trust might not be appropriate in every situation. However, a trustee should at least consider conversion in the scenarios addressed below.

A. Implementation

Conversion might be particularly beneficial when a grantor intended to provide an income beneficiary with a steady stream of interest and dividends for life. For instance, where a grantor establishes a trust that qualifies for the marital deduction, the grantor may have intended to provide ongoing support to the surviving spouse. When market conditions fail to produce sufficient income to sustain the beneficiary, or where the trustee lacks the power to make discretionary principal distributions, conversion could also provide an alternative way to extend the trust's economic growth to the income beneficiary.

Conversion could provide a reasonable solution where, for example, the trustee lacks the power to make discretionary distributions of principal. This may be appropriate where the assets of the trust have grown but the trustee has no other way to disperse that appreciation to the income beneficiary.

Conversion might also be an alternative to litigation where beneficiaries and trustees are at odds over investment philosophy, and it might be the right choice if both the income and remainder beneficiaries would receive greater returns after converting.

A trustee may also consider conversion to achieve income tax advantages under the distributable net income regulations and section 643 of the code. Because the proposed regulations permit the trustee to include gains in distributable net income that would otherwise be characterized as capital gains, the trustee might seek conversion to obtain an additional level of flexibility and tax planning that would allow

capital gains to be distributed to beneficiaries for maximum tax savings.

Finally, conversion might be advantageous where income distributions fluctuate greatly from year to year. Conversion to a total return trust creates a more predictable income distribution and permits better distribution planning for both the trustee and the beneficiaries.

B. The Proper Distribution Percentage

Although the Act allows trustees and beneficiaries to negotiate a distribution percentage ranging from 3 to 5 percent, the number is fixed at 4 percent when a trustee alone converts the trust. Some beneficiaries may argue that, given historical market conditions, a 4 percent distribution percentage is inadequate.

Under conditions like the bear markets of the 1990s, a beneficiary might argue that an 8 or 10 percent distribution percentage would be more appropriate. Today, where many investors have suffered tremendous losses, a guaranteed 4 percent return probably looks much more attractive. However, even the equity markets regain strength and generate returns in excess of 10 percent such that a fixed distribution percentage is no longer favorable, a beneficiary still retains the option to reconvert a trust if it would be to his or her advantage.

C. Conversion and Income Tax

One unanswered question remains about the income tax effects of converting a beneficial interest from a mandatory income interest to a unitrust one – the possibility that the IRS will treat the conversion as a sale or exchange, thereby triggering income tax.

In Private Letter Ruling 2002-31-011, the IRS considered a similar issue when a beneficial interest was converted to a 7-percent unitrust interest.³⁵ The IRS ruled that the conversion would result in the realization of gain under section 1001, citing the seminal Supreme Court case *Cottage Savings Association v Commissioner*.³⁶ The IRS reasoned that "[the] Grandson's interest in the modified trust would entail legal entitlements different from those he currently possesses," noting that the new interest was "materially different" within the rule of *Cottage Savings* and, therefore, should be considered a realization event.

The query: when could a trustee be confident that conversion to a unitrust interest would not be "materially different?" Clearly, conversion under a state directed statute does not have income tax planning as its primary motivation; its purpose is merely to facilitate trust administration and beneficiary objectives. Ideally, forthcoming regulations under section 643 will eliminate this conundrum for taxpayers but until then, conversion is subject to this vagary, which taxpayers could approach by taking any of the following measures:

Ignore the risk despite this letter ruling. This is a dangerous option for the trustee, who must advise the beneficiary that the IRS could assert that the conversion triggered gain.

Request a ruling from the IRS before conversion. This is an expensive and time-consuming option, but provides the trustee and beneficiaries with certainty.

Wait for Treasury to issue final regulations under section 643 that address the issue.

Complete the conversion, but carefully include protective language. That language should indicate that (1) the unitrust amount paid each year is subject to revocation annually (by a third party), and (2) the unitrust distribution will be deemed to be a distribution first out of income to satisfy the mandatory income requirement, then as a discretionary principal distribution for the rest. Including this language implicates section 661 and, when combined with the annual revocation power, arguably prevents any argument that the conversion was a "sale" or "exchange" within the meaning of *Cottage Savings*.

VIII. Conclusion

According to some commentators, the Act will "allow Illinois to remain competitive as a home for trusts."³ It provides Illinois trustees and beneficiaries with an additional trust administration option, which has the potential to benefit both the income and the remainder beneficiary in ever changing market conditions. The Act allows a trustee to manage and invest trust assets to produce a greater overall return when existing distributions fail to serve the beneficiaries' best interests or carry out the grantor's original purposes.

In sum, the Act shifts the emphasis on the trustee's role from that of a mediator, balancing the beneficiaries' competing interests, to that of a prudent investor and manager, making investment decisions that create growth and increase return on the trust assets. By doing so, the Act combines the trustee's duties to invest prudently and act as a fiduciary for the benefit of both beneficiaries while allowing to profit from increased returns and participate in the growth of the trust's assets.

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1. Illinois State Senator Kirk W. Dillard (R-Hinsdale).
 2. Illinois State House Representative Mark H. Beaubien (R-Wauconda).
 3. 760 ILCS 15/4(a).
 4. 760 ILCS 5/5(a).
 5. 760 ILCS 5/5(a)(5).
 6. See Figure 1.
 7. *Id.*
 8. *Id.*
 9. See Figure 2.
 10. 760 ILCS 5/5.3(a)(2).
 11. 760 ILCS 5/5(a)(5).
 12. 760 ILCS 5/5.3(a)(1).

13. Id.

14. Id.

15. 760 ILCS 5/5.3(a)(2).

16. 760 ILCS 5/5.3(a)(3).

17. 760 ILCS 5/5.3(a)(4).

18. 760 ILCS 5/5.3(a)(5).

19. 760 ILCS 5/5.3(a)(6).

20. See discussion at VI.

21. The term "primary beneficiary" is defined in section 16.1(b) of the Trusts and Trustees Act to mean beneficiary who is either: "(1) currently entitled or eligible to receive any portion of the trust income principal, or (2) assuming nonexercise of all powers of appointment, will receive, or be entitled to withdraw, all or a portion of the principal of the trust, if the beneficiary survives to the final date of distribution with respect to the beneficiary's share." 760 ILCS 5/16.1(b).

22. 760 ILCS 5/5.3(c)(3).

23. 760 ILCS 5/5.3(c)(4).

24. 760 ILCS 5/5.3(c)(6).

25. 760 ILCS 5/5.3(d)(2).

26. 26 USC § 643.

27. See *Definition of Income for Trust Purposes*, 66 Fed Reg 10396 (2001) (to be codified at 26 CFR 1.643(a)-1) (proposed February 15, 2001).

28. See *Id.*, 66 Fed Reg at 10400 (to be codified at 26 CFR § 1.643(a)-1(b)(3)).

29. Id.

30. 66 Fed Reg at 10397 (February 15, 2001).

31. 760 ILCS 5/5.3(h).

32. See 26 USC § 2056(b)(7)(B)(ii).

33. Additionally, the amount of income distributed to the beneficiary remains subject to the limitation in section 5.3(h) that requires a trustee to pay all income (in the traditional sense of dividends and interest)

to the beneficiary where that amount exceeds the unitrust distribution amount.

34. 760 ILCS 5/5.3(i).

35. Priv Ltr Rul 2002-31-011 (May 6, 2002).

36. 499 US 554 (1991).

37. See Daniel C. Vock, *Ryan Inks Change in Trust Law*, Chicago Daily Law Bulletin, August 29, 2000 the legislation was an initiative of the Corporate Fiduciaries Association of Illinois.

Figure 1: Income distributed annually:
Total Return Trust vs. Traditional Reallocation Method

	Principal at Origination	Rate of Return	Income per year Y1	Income per year Y5	Income per year Y10	Total Income 10 years
Unitrust ¹	\$2 million	4%	80,000	83,028	82,355	825,236
Reallocation ²	\$1 m fixed	4%	40,000	40,000	45,209	426,043

1. The unitrust method in Figure 1 reflects a trust with \$2 million of assets that the trustee then invests in fixed income investments that provide a 4-percent rate of return. Under the Total Return Trust Act, the annual income distribution is calculated by applying the distribution percentage (here also 4 percent) against the average fair market value of the trust's assets over the lesser of the preceding three years of the period in which the trust has been in existence.

2. The reallocation method assumes that the trustee invests \$1 million of the trust (50 percent of the trust assets) in fixed income investments that produce a rate of return of 4 percent. At the end of year five the assets are reallocated and capital gains taxes are assessed at a rate of 23 percent.

Figure 2: Allocation vs. Unitrust: Income and Principal Distributable Over 30 years

	Principal at Origination	Rate of Return	End of Y1	End of Y10	End of Y20	End of Y30	TOTAL
Unitrust Income Distribution	\$2 million	4%	80,000	82,355	80,990	79,648	\$2,400,000 total income
Unitrust Capital	\$2 million	6%	2,037,600	2,401,463	2,880,636	3,445,422	\$3,445,422 remainder

Appreciation							interest
Reallocation Income Distribution	\$1 million	4%	40,000	45,987	60,252	79,637	\$1,737,771 total income
Reallocation Capital Appreciation	\$1 million	6%	1,060,000	1,538,511	2,015,777	2,664,311	\$2,664,311 remainder interest

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