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States Ease Rules on Tapping Into Trust Funds

By JOHN KIMELMAN

The long bull markets of the 1980's and 90's frustrated many people who received income from trust funds that had been established three or more generations earlier.

As the capital in their accounts swelled, their income often declined because interest and dividend yields dropped. Even when the income generated by a mix of stocks and bonds fell below 2 percent or so of the fund's total value, many trustees were not permitted to distribute any of that growing principal to the trusts' beneficiaries.

Help has begun to arrive for the tens of thousands of those beneficiaries, but the solutions are neither simple nor uncontentious. Many state legislatures have recently adopted laws allowing trustees to pay out some of that principal, as well as income. But the fiduciary responsibility of the trustees involves complex legal issues, as does the task of harmonizing the intentions of the trusts' founders and current and future beneficiaries. Many trustees are debating just how far laws should go to alter time-honored methods for distributing money.

"These new laws mean trustees will have more decisions to make than before," said Robert Wolf, a trust lawyer in Pittsburgh. "And having choices can either be a great strength or a great weakness."

In the most common approach to the problem so far at least 24 states, including New York, New Jersey, Connecticut and California, have given trustees the power to adjust formerly irrevocable income-bearing trusts, many of which were established by long-departed family members. Under this system, a trustee has the discretion each year to decide how much of a trust fund's total value can be paid out.

In addition, four states — New York, Delaware, Missouri and Maine — have given trustees the choice of converting a traditional income-bearing trust fund into a legal entity known as a "total return unitrust," under which trustees must set a fixed portion of the portfolio's entire value as an annual disbursement to beneficiaries. Generally, that portion cannot be freely adjusted in later years. New York's law, which became effective at the beginning of this year, prescribes a 4 percent payout rate, while Delaware allows trusts to choose a rate between 3 and 5 percent. Lawmakers in Florida have passed a unitrust bill that awaits gubernatorial signature before becoming law. In Iowa, a new unitrust law wasexpected to go into effect shortly.

Some trust institutions, including PNC Bank (news/quote) and Wilmington Trust (news/quote), are using unitrust laws to convert old-fashioned income trusts into accounts that pay out a total return. Other institutions, like State Street Global Advisors and Deutsche Bank (news/quote), are focusing on using the power to adjust to give beneficiaries the ability to tap into principal.

But the total-return legislation has prompted a complex financial debate about how much of a fund's total value can be disbursed to current beneficiaries without endangering the solvency of the trust. Opinion is also divided about which legal approach — the total return unitrust or the power to adjust — is preferable.

For trustees, the stakes can be huge. A trustee perceived as favoring, say, current over future beneficiaries, might face a court suit. Such actions, most of which are settled before they arrive in court, have become more common in the last two years, said Dominic Campisi, a fiduciary lawyer based in San Francisco.

Some executives say laws that set or allow fixed withdrawal rates of 4 percent or more of an account's market value can jeopardize the account's viability.

"We are in agreement with the power to adjust because it at least gives the trustee flexibility over the years," said Andrew Gallivan, a managing director in charge of trusts and estates for the private-banking unit of Deutsche Bank. "But we don't like laws like New York's unitrust law."

Once a trustee chooses to set a certain payout percentage, Mr. Gallivan said, there is no other simple way to reverse the decision except by petitioning the court. "Someone is going to look back and say that while 4 percent might have looked good in 2002, it doesn't look so good at some point in the future," Mr. Gallivan said.

Deutsche Bank contends that a trust that invests 65 percent of its assets in stocks and 35 percent in bonds has an 80 percent chance of maintaining its inflation-adjusted value over 20 years if the annual payout is 3 percent of market value. But if the payout is pushed up to 4 percent, the bank says, the probability of the fund maintaining its purchasing power falls to 40 percent. A payout of 5 percent lowers the probability to a mere 5 percent.

These calculations make four assumptions: a gain of 10 percent a year on stock investments that mirror the Standard & Poor's 500; a return on fixed-income investments of 5 percent a year, an annual inflation rate of 2.5 percent and annual trust fees of 1 percent.

Charles Aulino, a first vice president for personal financial planning at Glenmede Trust, a trust company in Philadelphia, also questions the ability of an "all weather" payout rate of 4 percent or more to work for either current or future beneficiaries. His suspicions grew after he saw a study in an American Bar Association publication showing what would happen over 30 years to a trust that was invested 60 percent in the S.& P. 500 and 40 percent in government and corporate bonds. The results yielded a range of possible payouts and account balances after 30 years that were too divergent for comfort.

But others regard the automatic payouts in a unitrust approach as having at least one clear advantage over the "power to adjust" approach — more protection from legal action. A trustee who used his discretion to adjust a trust's distribution every few years would be exposed to lawsuits if current or future beneficiaries did not like the outcome, said Matthew Lynch, the chief fiduciary officer at Wilmington Trust. "That makes trustees really sweat," he said.

Trust advisers including Mr. Lynch also see circumstances in which payouts of 4 percent or more are acceptable. Michael Kresh, a certified financial planner in Hauppauge, N.Y., has performed his own analysis using return data from the last 30 years and found that a portfolio with an average annual pretax return of 10.5 percent grew even with a yearly payout of 5 percent and adjustment for inflation.

Mr. Kresh says the return assumptions in Deutsche Bank's calculations may be overly modest. Those assumptions are in keeping, he says, with the investment philosophy of most banks and trust departments. "For them to believe that a 4 percent payout will likely wipe out the trust's purchasing power, that means that they believe that they can't earn a yearly gross return of 7.5 percent before you take out for inflation and fees," he said. "But historically, going back 60 years, we have rates of return that are at least one to two percentage points higher for a portfolio like that."

Watching this debate from the sidelines are income trust beneficiaries, some of whom lead fairly modest lives. A 49-year-old software developer from Chicago believes that his late grandfather would have approved of a change in the terms of the family trust, which was set up in the 1950's when stock and bonds yields were higher.

"My grandfather wanted our trust to last for three or more generations and he would want to make sure it was invested so it could grow," said the beneficiary who spoke on condition of anonymity. "With a total return trust, you can achieve the aims of the grantor, but in a different way than the fund was originally set up."