

DRAFT  
FOR DISCUSSION ONLY

# REVISED UNIFORM PRINCIPAL AND INCOME ACT

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NATIONAL CONFERENCE OF COMMISSIONERS  
ON UNIFORM STATE LAWS

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February 26-27, 2016 Drafting Committee Meeting

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February 19, 2016

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## **REPORTER'S PREFATORY NOTE**

I come to the role of Reporter for the Drafting Committee with some experience interpreting and applying the Uniform Principal and Income Act but without a personal agenda for how it might, should, or can be changed. In these annotations throughout the current text of the UPIA and Comments, I make observations and ask questions, without a commitment to any particular answer, in the hope of accommodating and perhaps even stimulating others to raise questions and identify concerns, possible objectives, and even potential solutions.

Ronald D. Aucutt  
February 19, 2016

# REVISED UNIFORM PRINCIPAL AND INCOME ACT

## PREFATORY NOTE

This revision of the 1931 Uniform Principal and Income Act and the 1962 Revised Uniform Principal and Income Act has two purposes.

One purpose is to revise the 1931 and the 1962 Acts. Revision is needed to support the now widespread use of the revocable living trust as a will substitute, to change the rules in those Acts that experience has shown need to be changed, and to establish new rules to cover situations not provided for in the old Acts, including rules that apply to financial instruments invented since 1962.

The other purpose is to provide a means for implementing the transition to an investment regime based on principles embodied in the Uniform Prudent Investor Act, especially the principle of investing for total return rather than a certain level of “income” as traditionally perceived in terms of interest, dividends, and rents.

### Revision of the 1931 and 1962 Acts

The prior Acts and this revision of those Acts deal with four questions affecting the rights of beneficiaries:

(1) How is income earned during the probate of an estate to be distributed to trusts and to persons who receive outright bequests of specific property, pecuniary gifts, and the residue?

(2) When an income interest in a trust begins (i.e., when a person who creates the trust dies or when she transfers property to a trust during life), what property is principal that will eventually go to the remainder beneficiaries and what is income?

(3) When an income interest ends, who gets the income that has been received but not distributed, or that is due but not yet collected, or that has accrued but is not yet due?

(4) After an income interest begins and before it ends, how should its receipts and disbursements be allocated to or between principal and income?

Changes in the traditional sections are of three types: new rules that deal with situations not covered by the prior Acts, clarification of provisions in the 1962 Act, and changes to rules in the prior Acts.

**New rules.** Issues addressed by some of the more significant new rules include:

(1) The application of the probate administration rules to revocable living trusts after the settlor’s death and to other terminating trusts. Articles 2 and 3.

1 (2) The payment of interest or some other amount on the delayed payment of an outright  
2 pecuniary gift that is made pursuant to a trust agreement instead of a will when the agreement or  
3 state law does not provide for such a payment. Section 201(3).  
4

5 (3) The allocation of net income from partnership interests acquired by the trustee other  
6 than from a decedent (the old Acts deal only with partnership interests acquired from a decedent).  
7 Section 401.  
8

9 (4) An “unincorporated entity” concept has been introduced to deal with businesses  
10 operated by a trustee, including farming and livestock operations, and investment activities in  
11 rental real estate, natural resources, timber, and derivatives. Section 403.  
12

13 (5) The allocation of receipts from discount obligations such as zero-coupon bonds.  
14 Section 406(b).  
15

16 (6) The allocation of net income from harvesting and selling timber between principal  
17 and income. Section 412.  
18

19 (7) The allocation between principal and income of receipts from derivatives, options,  
20 and asset-backed securities. Sections 414 and 415.  
21

22 (8) Disbursements made because of environmental laws. Section 502(a)(7).  
23

24 (9) Income tax obligations resulting from the ownership of S corporation stock and  
25 interests in partnerships. Section 505.  
26

27 (10) The power to make adjustments between principal and income to correct inequities  
28 caused by tax elections or peculiarities in the way the fiduciary income tax rules apply. Section  
29 506.  
30

31 **Clarifications and changes in existing rules.** A number of matters provided for in the  
32 prior Acts have been changed or clarified in this revision, including the following:  
33

34 (1) An income beneficiary’s estate will be entitled to receive only net income actually  
35 received by a trust before the beneficiary’s death and not items of accrued income. Section 303.  
36

37 (2) Income from a partnership is based on actual distributions from the partnership, in the  
38 same manner as corporate distributions. Section 401.  
39

40 (3) Distributions from corporations and partnerships that exceed 20% of the entity’s  
41 gross assets will be principal whether or not intended by the entity to be a partial liquidation.  
42 Section 401(d)(2).  
43

44 (4) Deferred compensation is dealt with in greater detail in a separate section. Section  
45 409.

1 (5) The 1962 Act rule for “property subject to depletion,” (patents, copyrights, royalties,  
2 and the like), which provides that a trustee may allocate up to 5% of the asset’s inventory value  
3 to income and the balance to principal, has been replaced by a rule that allocates 90% of the  
4 amounts received to principal and the balance to income. Section 410.

5  
6 (6) The percentage used to allocate amounts received from oil and gas has been changed  
7 – 90% of those receipts are allocated to principal and the balance to income. Section 411.

8  
9 (7) The unproductive property rule has been eliminated for trusts other than marital  
10 deduction trusts. Section 413.

11  
12 (8) Charging depreciation against income is no longer mandatory, and is left to the  
13 discretion of the trustee. Section 503.

### 14 **Coordination with the Uniform Prudent Investor Act**

15  
16 The law of trust investment has been modernized. See Uniform Prudent Investor Act  
17 (1994); Restatement (Third) of Trusts: Prudent Investor Rule (1992) (hereinafter Restatement of  
18 Trusts 3d: Prudent Investor Rule). Now it is time to update the principal and income allocation  
19 rules so the two bodies of doctrine can work well together. This revision deals conservatively  
20 with the tension between modern investment theory and traditional income allocation. The  
21 starting point is to use the traditional system. If prudent investing of all the assets in a trust  
22 viewed as a portfolio and traditional allocation effectuate the intent of the settlor, then nothing  
23 need be done. The Act, however, helps the trustee who has made a prudent, modern portfolio-  
24 based investment decision that has the initial effect of skewing return from all the assets under  
25 management, viewed as a portfolio, as between income and principal beneficiaries. The Act  
26 gives that trustee a power to reallocate the portfolio return suitably. To leave a trustee  
27 constrained by the traditional system would inhibit the trustee’s ability to fully implement  
28 modern portfolio theory.  
29

30  
31 As to modern investing see, e.g., the Preface to, terms of, and Comments to the Uniform  
32 Prudent Investor Act (1994); the discussion and reporter’s note by Edward C. Halbach, Jr. in  
33 Restatement of Trusts 3d: Prudent Investor Rule; John H. Langbein, *The Uniform Prudent*  
34 *Investor Act and the Future of Trust Investing*, 81 *Iowa L. Rev.* 641 (1996); Bevis Longstreth,  
35 *Modern Investment Management and the Prudent Man Rule* (1986); John H. Langbein & Richard  
36 A. Posner, *The Revolution in Trust Investment Law*, 62 *A.B.A.J.* 887 (1976); and Jeffrey N.  
37 Gordon, *The Puzzling Persistence of the Constrained Prudent Man Rule*, 62 *N.Y.U. L. Rev.* 52  
38 (1987). See also R.A. Brearly, *An Introduction to Risk and Return from Common Stocks* (2d ed.  
39 1983); Jonathan R. Macey, *An Introduction to Modern Financial Theory* (2d ed. 1998). As to the  
40 need for principal and income reform see, e.g., Joel C. Dobris, *Real Return, Modern Portfolio*  
41 *Theory and College, University and Foundation Decisions on Annual Spending From*  
42 *Endowments: A Visit to the World of Spending Rules*, 28 *Real Prop., Prob., & Tr. J.* 49 (1993);  
43 Joel C. Dobris, *The Probate World at the End of the Century: Is a New Principal and Income Act*  
44 *in Your Future?*, 28 *Real Prop., Prob., & Tr. J.* 393 (1993); and Kenneth L. Hirsch, *Inflation and*  
45 *the Law of Trusts*, 18 *Real Prop., Prob., & Tr. J.* 601 (1983). See also, Jerold I. Horn, *The*



- 1 Prudent Investor Rule – Impact on Drafting and Administration of Trusts, 20 ACTEC Notes 26
- 2 (Summer 1994).
- 3

1                                   **REVISED UNIFORM PRINCIPAL AND INCOME ACT**

2   **[ARTICLE] 1**

3   **DEFINITIONS AND FIDUCIARY DUTIES**

4                   **SECTION 101. SHORT TITLE.** This [Act] may be cited as the Uniform Principal and  
5 Income Act.

6                   **SECTION 102. DEFINITIONS.** In this [Act]:

7                   (1) “Accounting period” means a calendar year unless another 12-month period is  
8 selected by a fiduciary. The term includes a portion of a calendar year or other 12-month period  
9 that begins when an income interest begins or ends when an income interest ends.

10                   1.       Are we sure that a 52-53-week fiscal year, as in section 441(f) if the Internal  
11 Revenue Code, or some other fiscal year, would never be appropriate? RDA

12                   (2) “Beneficiary” includes, in the case of a decedent’s estate, an heir [, legatee,] and  
13 devisee and, in the case of a trust, an income beneficiary and a remainder beneficiary.

14                   (3) “Fiduciary” means a personal representative or a trustee. The term includes an  
15 executor, administrator, successor personal representative, special administrator, and a person  
16 performing substantially the same function.

17                   (4) “Income” means money or property that a fiduciary receives as current return from a  
18 principal asset. The term includes a portion of receipts from a sale, exchange, or liquidation of a  
19 principal asset, to the extent provided in [Article] 4.

20                   (5) “Income beneficiary” means a person to whom net income of a trust is or may be  
21 payable.

22                   (6) “Income interest” means the right of an income beneficiary to receive all or part of  
23 net income, whether the terms of the trust require it to be distributed or authorize it to be

1 distributed in the trustee’s discretion.

2 (7) “Mandatory income interest” means the right of an income beneficiary to receive net  
3 income that the terms of the trust require the fiduciary to distribute.

4 (8) “Net income” means the total receipts allocated to income during an accounting  
5 period minus the disbursements made from income during the period, plus or minus transfers  
6 under this [Act] to or from income during the period.

7 (9) “Person” means an individual, corporation, business trust, estate, trust, partnership,  
8 limited liability company, association, joint venture, government; governmental subdivision,  
9 agency, or instrumentality; public corporation, or any other legal or commercial entity.

10 (10) “Principal” means property held in trust for distribution to a remainder beneficiary  
11 when the trust terminates.

12 (11) “Remainder beneficiary” means a person entitled to receive principal when an  
13 income interest ends.

14 (12) “Terms of a trust” means the manifestation of the intent of a settlor or decedent with  
15 respect to the trust, expressed in a manner that admits of its proof in a judicial proceeding,  
16 whether by written or spoken words or by conduct.

17 (13) “Trustee” includes an original, additional, or successor trustee, whether or not  
18 appointed or confirmed by a court.

19 **Comment**

20 **“Income beneficiary.”** The definitions of income beneficiary (Section 102(5)) and  
21 income interest (Section 102(6)) cover both mandatory and discretionary beneficiaries and  
22 interests. There are no definitions for “discretionary income beneficiary” or “discretionary  
23 income interest” because those terms are not used in the Act.  
24

25 **Inventory value.** There is no definition for inventory value in this Act because the  
26 provisions in which that term was used in the 1962 Act have either been eliminated (in the case

1 of the underproductive property provision) or changed in a way that eliminates the need for the  
2 term (in the case of bonds and other money obligations, property subject to depletion, and the  
3 method for determining entitlement to income distributed from a probate estate).  
4

5 **“Net income.”** The reference to “transfers under this Act to or from income” means  
6 transfers made under Sections 104(a), 412(b), 502(b), 503(b), 504(a), and 506.  
7

8 **“Terms of a trust.”** This term was chosen in preference to “terms of the trust  
9 instrument” (the phrase used in the 1962 Act) to make it clear that the Act applies to oral trusts as  
10 well as those whose terms are expressed in written documents. The definition is based on the  
11 Restatement (Second) of Trusts § 4 (1959) and the Restatement (Third) of Trusts § 4 (Tent. Draft  
12 No. 1, 1996). Constructional preferences or rules would also apply, if necessary, to determine the  
13 terms of the trust.  
14

15 **SECTION 103. FIDUCIARY DUTIES; GENERAL PRINCIPLES.**

16 (a) In allocating receipts and disbursements to or between principal and income, and with  
17 respect to any matter within the scope of [Articles] 2 and 3, a fiduciary:

18 (1) shall administer a trust or estate in accordance with the terms of the trust or the  
19 will, even if there is a different provision in this [Act];

20 2. See my annotation to section 601 regarding the difference between rules of  
21 construction and rules of administration. RDA

22 (2) may administer a trust or estate by the exercise of a discretionary power of  
23 administration given to the fiduciary by the terms of the trust or the will, even if the exercise of  
24 the power produces a result different from a result required or permitted by this [Act];

25 3. Many states (*e.g.*, HI, ID, IN, KY, MT, NE, NH, PA, WV, WY) add an explicit  
26 disclaimer of any negative “inference” of improper exercise if a trustee acts contrary  
27 to the Act. RDA

28 (3) shall administer a trust or estate in accordance with this [Act] if the terms of  
29 the trust or the will do not contain a different provision or do not give the fiduciary a  
30 discretionary power of administration; and

31 (4) shall add a receipt or charge a disbursement to principal to the extent that the

1 terms of the trust and this [Act] do not provide a rule for allocating the receipt or disbursement to  
2 or between principal and income.

3 (b) In exercising the power to adjust under Section 104(a) or a discretionary power of  
4 administration regarding a matter within the scope of this [Act], whether granted by the terms of  
5 a trust, a will, or this [Act], a fiduciary shall administer a trust or estate impartially, based on  
6 what is fair and reasonable to all of the beneficiaries, except to the extent that the terms of the  
7 trust or the will clearly manifest an intention that the fiduciary shall or may favor one or more of  
8 the beneficiaries. A determination in accordance with this [Act] is presumed to be fair and  
9 reasonable to all of the beneficiaries.

10 4. Is the phrase “to the extent” sufficient to permit the terms of the trust to alter  
11 the degree or nature of impartiality without abandoning the duty of impartiality? For  
12 example, is it clear that the terms of the trust may permit a current beneficiary to be  
13 preferred to meet her needs for support in accordance with her accustomed standard  
14 of living and for medical care, but that in making determinations regarding that  
15 standard the trustee owes a duty of impartiality to the current beneficiary and the  
16 successive or remainder beneficiaries? Or, if such a preference for support and health  
17 is expressed, does this law preserve the duty of impartiality in making discretionary  
18 distributions once that standard is satisfied? RDA

19 **Comment**

20 **Prior Act.** The rule in Section 2(a) of the 1962 Act is restated in Section 103(a), without  
21 changing its substance, to emphasize that the Act contains only default rules and that provisions  
22 in the terms of the trust are paramount. However, Section 2(a) of the 1962 Act applies only to the  
23 allocation of receipts and disbursements to or between principal and income. In this Act, the first  
24 sentence of Section 103(a) states that it also applies to matters within the scope of Articles 2 and  
25 3. Section 103(a)(2) incorporates the rule in Section 2(b) of the 1962 Act that a discretionary  
26 allocation made by the trustee that is contrary to a rule in the Act should not give rise to an  
27 inference of imprudence or partiality by the trustee.

28  
29 The Act deletes the language that appears at the end of 1962 Act Section 2(a)(3) – “and in  
30 view of the manner in which men of ordinary prudence, discretion and judgment would act in the  
31 management of their affairs” – because persons of ordinary prudence, discretion and judgment,  
32 acting in the management of their own affairs do not normally think in terms of the interests of  
33 successive beneficiaries. If there is an analogy to an individual’s decision-making process, it is  
34 probably the individual’s decision to spend or to save, but this is not a useful guideline for trust

1 administration. No case has been found in which a court has relied on the “prudent man” rule of  
2 the 1962 Act.

3  
4 **Fiduciary discretion.** The general rule is that if a discretionary power is conferred upon  
5 a trustee, the exercise of that power is not subject to control by a court except to prevent an abuse  
6 of discretion. Restatement (Second) of Trusts § 187. The situations in which a court will control  
7 the exercise of a trustee’s discretion are discussed in the comments to § 187. See also *id.* § 233  
8 Comment *p.*

9  
10 **Questions for which there is no provision.** Section 103(a)(4) allocates receipts and  
11 disbursements to principal when there is no provision for a different allocation in the terms of the  
12 trust, the will, or the Act. This may occur because money is received from a financial instrument  
13 not available at the present time (inflation-indexed bonds might have fallen into this category had  
14 they been announced after this Act was approved by the Commissioners on Uniform State Laws)  
15 or because a transaction is of a type or occurs in a manner not anticipated by the Drafting  
16 Committee for this Act or the drafter of the trust instrument.

17  
18 

5. Have other such instruments now come into use? If so, does that matter? Is 19 allocation to principal always the right default? RDA
---

20 Allocating to principal a disbursement for which there is no provision in the Act or the  
21 terms of the trust preserves the income beneficiary’s level of income in the year it is allocated to  
22 principal, but thereafter will reduce the amount of income produced by the principal. Allocating  
23 to principal a receipt for which there is no provision will increase the income received by the  
24 income beneficiary in subsequent years, and will eventually, upon termination of the trust, also  
25 favor the remainder beneficiary. Allocating these items to principal implements the rule that  
26 requires a trustee to administer the trust impartially, based on what is fair and reasonable to both  
27 income and remainder beneficiaries. However, if the trustee decides that an adjustment between  
28 principal and income is needed to enable the trustee to comply with Section 103(b), after  
29 considering the return from the portfolio as a whole, the trustee may make an appropriate  
30 adjustment under Section 104(a).

31  
32 **Duty of impartiality.** Whenever there are two or more beneficiaries, a trustee is under a  
33 duty to deal impartially with them. Restatement of Trusts 3d: Prudent Investor Rule § 183  
34 (1992). This rule applies whether the beneficiaries’ interests in the trust are concurrent or  
35 successive. If the terms of the trust give the trustee discretion to favor one beneficiary over  
36 another, a court will not control the exercise of such discretion except to prevent the trustee from  
37 abusing it. *Id.* § 183, Comment *a.* “The precise meaning of the trustee’s duty of impartiality and  
38 the balancing of competing interests and objectives inevitably are matters of judgment and  
39 interpretation. Thus, the duty and balancing are affected by the purposes, terms, distribution  
40 requirements, and other circumstances of the trust, not only at the outset but as they may change  
41 from time to time.” *Id.* § 232, Comment *c.*

42  
43 

The terms of a trust may provide that the trustee, or an accountant engaged by the trustee, 44 or a committee of persons who may be family members or business associates, shall have the
--

1 power to determine what is income and what is principal. If the terms of a trust provide that this  
2 Act specifically or principal and income legislation in general does not apply to the trust but fail  
3 to provide a rule to deal with a matter provided for in this Act, the trustee has an implied grant of  
4 discretion to decide the question. Section 103(b) provides that the rule of impartiality applies in  
5 the exercise of such a discretionary power to the extent that the terms of the trust do not provide  
6 that one or more of the beneficiaries are to be favored. The fact that a person is named an  
7 income beneficiary or a remainder beneficiary is not by itself an indication of partiality for that  
8 beneficiary.

9  
10 6. Does the Act authorize such action by an accountant or committee? Should  
11 it? RDA

12 **SECTION 104. TRUSTEE’S POWER TO ADJUST.**

13 (a) A trustee may adjust between principal and income to the extent the trustee considers  
14 necessary if the trustee invests and manages trust assets as a prudent investor, the terms of the  
15 trust describe the amount that may or must be distributed to a beneficiary by referring to the  
16 trust’s income, and the trustee determines, after applying the rules in Section 103(a), that the  
17 trustee is unable to comply with Section 103(b).

18 7. Are there any other circumstances in which adjustment would be appropriate?  
19 Is the limitation to trusts where the amount of income determines or constrains  
20 distributions too narrow? RDA

21 (b) In deciding whether and to what extent to exercise the power conferred by subsection  
22 (a), a trustee shall consider all factors relevant to the trust and its beneficiaries, including the  
23 following factors to the extent they are relevant:

24 (1) the nature, purpose, and expected duration of the trust;

25 (2) the intent of the settlor;

26 (3) the identity and circumstances of the beneficiaries;

27 (4) the needs for liquidity, regularity of income, and preservation and appreciation  
28 of capital;

29 (5) the assets held in the trust; the extent to which they consist of financial assets,

1 interests in closely held enterprises, tangible and intangible personal property, or real property;  
2 the extent to which an asset is used by a beneficiary; and whether an asset was purchased by the  
3 trustee or received from the settlor;

4 (6) the net amount allocated to income under the other sections of this [Act] and  
5 the increase or decrease in the value of the principal assets, which the trustee may estimate as to  
6 assets for which market values are not readily available;

7 (7) whether and to what extent the terms of the trust give the trustee the power to  
8 invade principal or accumulate income or prohibit the trustee from invading principal or  
9 accumulating income, and the extent to which the trustee has exercised a power from time to  
10 time to invade principal or accumulate income;

11 (8) the actual and anticipated effect of economic conditions on principal and  
12 income and effects of inflation and deflation; and

13 (9) the anticipated tax consequences of an adjustment.

14 8. In section 104(b)(9) some states (*e.g.*, AL) say “the anticipated *income and*  
15 *transfer* tax consequences of an adjustment.” Should the Uniform Act say that?  
16 Could there be unintended tax consequences of the apparently ability to manipulate  
17 distributions for transfer tax purposes? RDA

18 9. What if a trustee establishes a protocol of, say, adjusting income to a target  
19 percentage of the value of the trust assets each year (a “unitrust” amount)? How  
20 rigorously does consideration of these standards need to be undertaken (and  
21 documented) each year? Does it matter if state statutory law expressly allows  
22 conversion to a “unitrust”? RDA

23 (c) A trustee may not make an adjustment:

24 (1) that diminishes the income interest in a trust that requires all of the income to  
25 be paid at least annually to a spouse and for which an estate tax or gift tax marital deduction  
26 would be allowed, in whole or in part, if the trustee did not have the power to make the



1 adjustment;

2 (2) that reduces the actuarial value of the income interest in a trust to which a  
3 person transfers property with the intent to qualify for a gift tax exclusion;

4 (3) that changes the amount payable to a beneficiary as a fixed annuity or a fixed  
5 fraction of the value of the trust assets;

6 (4) from any amount that is permanently set aside for charitable purposes under a  
7 will or the terms of a trust unless both income and principal are so set aside;

8 (5) if possessing or exercising the power to make an adjustment causes an  
9 individual to be treated as the owner of all or part of the trust for income tax purposes, and the  
10 individual would not be treated as the owner if the trustee did not possess the power to make an  
11 adjustment;

12 (6) if possessing or exercising the power to make an adjustment causes all or part  
13 of the trust assets to be included for estate tax purposes in the estate of an individual who has the  
14 power to remove a trustee or appoint a trustee, or both, and the assets would not be included in  
15 the estate of the individual if the trustee did not possess the power to make an adjustment;

16 (7) if the trustee is a beneficiary of the trust; or

17 (8) if the trustee is not a beneficiary, but the adjustment would benefit the trustee  
18 directly or indirectly.

19 (d) If subsection (c)(5), (6), (7), or (8) applies to a trustee and there is more than one  
20 trustee, a cotrustee to whom the provision does not apply may make the adjustment unless the  
21 exercise of the power by the remaining trustee or trustees is not permitted by the terms of the  
22 trust.

23 (e) A trustee may release the entire power conferred by subsection (a) or may release only

1 the power to adjust from income to principal or the power to adjust from principal to income if  
2 the trustee is uncertain about whether possessing or exercising the power will cause a result  
3 described in subsection (c)(1) through (6) or (c)(8) or if the trustee determines that possessing or  
4 exercising the power will or may deprive the trust of a tax benefit or impose a tax burden not  
5 described in subsection (c). The release may be permanent or for a specified period, including a  
6 period measured by the life of an individual.

7 (f) Terms of a trust that limit the power of a trustee to make an adjustment between  
8 principal and income do not affect the application of this section unless it is clear from the terms  
9 of the trust that the terms are intended to deny the trustee the power of adjustment conferred by  
10 subsection (a).

- |    |  |
|----|--|
| 11 | 10. Some states ( <i>e.g.</i> , IA, NY, ND) omit this section.                               |
| 12 | 11. Some states ( <i>e.g.</i> , CO, FL, MT) state that this section does not create a “duty” |
| 13 | to adjust. Is that a good idea? (Section 4 of the new Uniform Trust Decanting Act            |
| 14 | states that there is no duty to decant, but that if decanting is done, it must be done in    |
| 15 | accordance with the trustee’s fiduciary duties.) RDA   |
| 16 | 12. Other states ( <i>e.g.</i> , KY, PA) explicitly authorize a trustee to release the power |
| 17 | to adjust. Why would a trustee ever do that? Just to avoid being badgered by                 |
| 18 | beneficiaries? Is that an appropriate fiduciary reason? RDA                                  |

19 **Comment**

20 **Purpose and Scope of Provision.** The purpose of Section 104 is to enable a trustee to  
21 select investments using the standards of a prudent investor without having to realize a particular  
22 portion of the portfolio’s total return in the form of traditional trust accounting income such as  
23 interest, dividends, and rents. Section 104(a) authorizes a trustee to make adjustments between  
24 principal and income if three conditions are met: (1) the trustee must be managing the trust assets  
25 under the prudent investor rule; (2) the terms of the trust must express the income beneficiary’s  
26 distribution rights in terms of the right to receive “income” in the sense of traditional trust  
27 accounting income; and (3) the trustee must determine, after applying the rules in Section 103(a),  
28 that he is unable to comply with Section 103(b). In deciding whether and to what extent to  
29 exercise the power to adjust, the trustee is required to consider the factors described in Section  
30 104(b), but the trustee may not make an adjustment in circumstances described in Section 104(c).

31  
32 Section 104 does not empower a trustee to increase or decrease the degree of beneficial

1 enjoyment to which a beneficiary is entitled under the terms of the trust; rather, it authorizes the  
2 trustee to make adjustments between principal and income that may be necessary if the income  
3 component of a portfolio's total return is too small or too large because of investment decisions  
4 made by the trustee under the prudent investor rule. The paramount consideration in applying  
5 Section 104(a) is the requirement in Section 103(b) that "a fiduciary must administer a trust or  
6 estate impartially, based on what is fair and reasonable to all of the beneficiaries, except to the  
7 extent that the terms of the trust or the will clearly manifest an intention that the fiduciary shall or  
8 may favor one or more of the beneficiaries." The power to adjust is subject to control by the  
9 court to prevent an abuse of discretion. Restatement (Second) of Trusts § 187 (1959). See also  
10 id. §§ 183, 232, 233, Comment *p* (1959).

11  
12 Section 104 will be important for trusts that are irrevocable when a State adopts the  
13 prudent investor rule by statute or judicial approval of the rule in Restatement of Trusts 3d:  
14 Prudent Investor Rule. Wills and trust instruments executed after the rule is adopted can be  
15 drafted to describe a beneficiary's distribution rights in terms that do not depend upon the amount  
16 of trust accounting income, but to the extent that drafters of trust documents continue to describe  
17 an income beneficiary's distribution rights by referring to trust accounting income, Section 104  
18 will be an important tool in trust administration.

19  
20 **Three conditions to the exercise of the power to adjust.** The first of the three  
21 conditions that must be met before a trustee can exercise the power to adjust – that the trustee  
22 invest and manage trust assets as a prudent investor – is expressed in this Act by language  
23 derived from the Uniform Prudent Investor Act, but the condition will be met whether the  
24 prudent investor rule applies because the Uniform Act or other prudent investor legislation has  
25 been enacted, the prudent investor rule has been approved by the courts, or the terms of the trust  
26 require it. Even if a State's legislature or courts have not formally adopted the rule, the  
27 Restatement establishes the prudent investor rule as an authoritative interpretation of the  
28 common law prudent man rule, referring to the prudent investor rule as a "modest reformulation  
29 of the Harvard College dictum and the basic rule of prior Restatements." Restatement of Trusts  
30 3d: Prudent Investor Rule, Introduction, at 5. As a result, there is a basis for concluding that the  
31 first condition is satisfied in virtually all States except those in which a trustee is permitted to  
32 invest only in assets set forth in a statutory "legal list."

33  
34 The second condition will be met when the terms of the trust require all of the "income"  
35 to be distributed at regular intervals; or when the terms of the trust require a trustee to distribute  
36 all of the income, but permit the trustee to decide how much to distribute to each member of a  
37 class of beneficiaries; or when the terms of a trust provide that the beneficiary shall receive the  
38 greater of the trust accounting income and a fixed dollar amount (an annuity), or of trust  
39 accounting income and a fractional share of the value of the trust assets (a unitrust amount). If  
40 the trust authorizes the trustee in its discretion to distribute the trust's income to the beneficiary  
41 or to accumulate some or all of the income, the condition will be met because the terms of the  
42 trust do not permit the trustee to distribute more than the trust accounting income.

43  
44 To meet the third condition, the trustee must first meet the requirements of Section  
45 103(a), i.e., she must apply the terms of the trust, decide whether to exercise the discretionary

1 powers given to the trustee under the terms of the trust, and must apply the provisions of the Act  
2 if the terms of the trust do not contain a different provision or give the trustee discretion.  
3 Second, the trustee must determine the extent to which the terms of the trust clearly manifest an  
4 intention by the settlor that the trustee may or must favor one or more of the beneficiaries. To the  
5 extent that the terms of the trust do not require partiality, the trustee must conclude that she is  
6 unable to comply with the duty to administer the trust impartially. To the extent that the terms of  
7 the trust do require or permit the trustee to favor the income beneficiary or the remainder  
8 beneficiary, the trustee must conclude that she is unable to achieve the degree of partiality  
9 required or permitted. If the trustee comes to either conclusion - that she is unable to administer  
10 the trust impartially or that she is unable to achieve the degree of partiality required or permitted -  
11 she may exercise the power to adjust under Section 104(a).  
12

13 **Impartiality and productivity of income.** The duty of impartiality between income and  
14 remainder beneficiaries is linked to the trustee’s duty to make the portfolio productive of trust  
15 accounting income whenever the distribution requirements are expressed in terms of distributing  
16 the trust’s “income.” The 1962 Act implies that the duty to produce income applies on an asset  
17 by asset basis because the right of an income beneficiary to receive “delayed income” from the  
18 sale proceeds of underproductive property under Section 12 of that Act arises if “any part of  
19 principal ... has not produced an average net income of a least 1% per year of its inventory value  
20 for more than a year ... .” Under the prudent investor rule, “[t]o whatever extent a requirement of  
21 income productivity exists, ... the requirement applies not investment by investment but to the  
22 portfolio as a whole.” Restatement of Trusts 3d: Prudent Investor Rule § 227, Comment *i*, at 34.  
23 The power to adjust under Section 104(a) is also to be exercised by considering net income from  
24 the portfolio as a whole and not investment by investment. Section 413(b) of this Act eliminates  
25 the underproductive property rule in all cases other than trusts for which a marital deduction is  
26 allowed; the rule applies to a marital deduction trust if the trust’s assets “consist substantially of  
27 property that does not provide the spouse with sufficient income from or use of the trust assets  
28 ...” – in other words, the section applies by reference to the portfolio as a whole.  
29

30 13. It looks like the quoted phrase should be “at least”, not “a least”. RDA

31 While the purpose of the power to adjust in Section 104(a) is to eliminate the need for a  
32 trustee who operates under the prudent investor rule to be concerned about the income  
33 component of the portfolio’s total return, the trustee must still determine the extent to which a  
34 distribution must be made to an income beneficiary and the adequacy of the portfolio’s liquidity  
35 as a whole to make that distribution.  
36

37 For a discussion of investment considerations involving specific investments and  
38 techniques under the prudent investor rule, see Restatement of Trusts 3d: Prudent Investor Rule  
39 § 227, Comments *k-p*.  
40

41 **Factors to consider in exercising the power to adjust.** Section 104(b) requires a trustee  
42 to consider factors relevant to the trust and its beneficiaries in deciding whether and to what  
43 extent the power to adjust should be exercised. Section 2(c) of the Uniform Prudent Investor Act  
44 sets forth circumstances that a trustee is to consider in investing and managing trust assets. The

1 circumstances in Section 2(c) of the Uniform Prudent Investor Act are the source of the factors in  
2 paragraphs (3) through (6) and (8) of Section 104(b) (modified where necessary to adapt them to  
3 the purposes of this Act) so that, to the extent possible, comparable factors will apply to  
4 investment decisions and decisions involving the power to adjust. If a trustee who is operating  
5 under the prudent investor rule decides that the portfolio should be composed of financial assets  
6 whose total return will result primarily from capital appreciation rather than dividends, interest,  
7 and rents, the trustee can decide at the same time the extent to which an adjustment from  
8 principal to income may be necessary under Section 104. On the other hand, if a trustee decides  
9 that the risk and return objectives for the trust are best achieved by a portfolio whose total return  
10 includes interest and dividend income that is sufficient to provide the income beneficiary with  
11 the beneficial interest to which the beneficiary is entitled under the terms of the trust, the trustee  
12 can decide that it is unnecessary to exercise the power to adjust.

13  
14 **Assets received from the settlor.** Section 3 of the Uniform Prudent Investor Act  
15 provides that “[a] trustee shall diversify the investments of the trust unless the trustee reasonably  
16 determines that, because of special circumstances, the purposes of the trust are better served  
17 without diversifying.” The special circumstances may include the wish to retain a family  
18 business, the benefit derived from deferring liquidation of the asset in order to defer payment of  
19 income taxes, or the anticipated capital appreciation from retaining an asset such as undeveloped  
20 real estate for a long period. To the extent the trustee retains assets received from the settlor  
21 because of special circumstances that overcome the duty to diversify, the trustee may take these  
22 circumstances into account in determining whether and to what extent the power to adjust should  
23 be exercised to change the results produced by other provisions of this Act that apply to the  
24 retained assets. See Section 104(b)(5); Uniform Prudent Investor Act § 3, Comment, 7B U.L.A.  
25 18, at 25-26 (Supp. 1997); Restatement of Trusts 3d: Prudent Investor Rule § 229 and Comments  
26 *a-e*.

27  
28 **Limitations on the power to adjust.** The purpose of subsections (c)(1) through (4) is to  
29 preserve tax benefits that may have been an important purpose for creating the trust. Subsections  
30 (c)(5), (6), and (8) deny the power to adjust in the circumstances described in those subsections  
31 in order to prevent adverse tax consequences, and subsection (c)(7) denies the power to adjust to  
32 any beneficiary, whether or not possession of the power may have adverse tax consequences.

33  
34 Under subsection (c)(1), a trustee cannot make an adjustment that diminishes the income  
35 interest in a trust that requires all of the income to be paid at least annually to a spouse and for  
36 which an estate tax or gift tax marital deduction is allowed; but this subsection does not prevent  
37 the trustee from making an adjustment that increases the amount of income paid from a marital  
38 deduction trust to the spouse. Subsection (c)(1) applies to a trust that qualifies for the marital  
39 deduction because the spouse has a general power of appointment over the trust, but it applies to  
40 a qualified terminable interest property (QTIP) trust only if and to the extent that the fiduciary  
41 makes the election required to obtain the tax deduction. Subsection (c)(1) does not apply to a so-  
42 called “estate” trust. This type of trust qualifies for the marital deduction because the terms of  
43 the trust require the principal and undistributed income to be paid to the surviving spouse’s estate  
44 when the spouse dies; it is not necessary for the terms of an estate trust to require the income to  
45 be distributed annually. Reg. § 20.2056(c)-2(b)(1)(iii).

1 Subsection (c)(3) applies to annuity trusts and unitrusts with no charitable beneficiaries as  
2 well as to trusts with charitable income or remainder beneficiaries; its purpose is to make it clear  
3 that a beneficiary's right to receive a fixed annuity or a fixed fraction of the value of a trust's  
4 assets is not subject to adjustment under Section 104(a). Subsection (c)(3) does not apply to any  
5 additional amount to which the beneficiary may be entitled that is expressed in terms of a right to  
6 receive income from the trust. For example, if a beneficiary is to receive a fixed annuity or the  
7 trust's income, whichever is greater, subsection (c)(3) does not prevent a trustee from making an  
8 adjustment under Section 104(a) in determining the amount of the trust's income.  
9

10 If subsection (c)(5), (6), (7), or (8), prevents a trustee from exercising the power to adjust,  
11 subsection (d) permits a cotrustee who is not subject to the provision to exercise the power unless  
12 the terms of the trust do not permit the cotrustee to do so.  
13

14 **Release of the power to adjust.** Section 104(e) permits a trustee to release all or part of  
15 the power to adjust in circumstances in which the possession or exercise of the power might  
16 deprive the trust of a tax benefit or impose a tax burden. For example, if possessing the power  
17 would diminish the actuarial value of the income interest in a trust for which the income  
18 beneficiary's estate may be eligible to claim a credit for property previously taxed if the  
19 beneficiary dies within ten years after the death of the person creating the trust, the trustee is  
20 permitted under subsection (e) to release just the power to adjust from income to principal.  
21

22 **Trust terms that limit a power to adjust.** Section 104(f) applies to trust provisions that  
23 limit a trustee's power to adjust. Since the power is intended to enable trustees to employ the  
24 prudent investor rule without being constrained by traditional principal and income rules, an  
25 instrument executed before the adoption of this Act whose terms describe the amount that may or  
26 must be distributed to a beneficiary by referring to the trust's income or that prohibit the invasion  
27 of principal or that prohibit equitable adjustments in general should not be construed as  
28 forbidding the use of the power to adjust under Section 104(a) if the need for adjustment arises  
29 because the trustee is operating under the prudent investor rule. Instruments containing such  
30 provisions that are executed after the adoption of this Act should specifically refer to the power  
31 to adjust if the settlor intends to forbid its use. See generally, Joel C. Dobris, Limits on the  
32 Doctrine of Equitable Adjustment in Sophisticated Postmortem Tax Planning, 66 Iowa L. Rev.  
33 273 (1981).  
34

35 **Examples.** The following examples illustrate the application of Section 104:  
36

37 **Example (1)** – T is the successor trustee of a trust that provides income to A for life,  
38 remainder to B. T has received from the prior trustee a portfolio of financial assets  
39 invested 20% in stocks and 80% in bonds. Following the prudent investor rule, T  
40 determines that a strategy of investing the portfolio 50% in stocks and 50% in bonds has  
41 risk and return objectives that are reasonably suited to the trust, but T also determines that  
42 adopting this approach will cause the trust to receive a smaller amount of dividend and  
43 interest income. After considering the factors in Section 104(b), T may transfer cash from  
44 principal to income to the extent T considers it necessary to increase the amount  
45 distributed to the income beneficiary.

1 **Example (2)** – T is the trustee of a trust that requires the income to be paid to the settlor’s  
2 son C for life, remainder to C’s daughter D. In a period of very high inflation, T  
3 purchases bonds that pay double-digit interest and determines that a portion of the  
4 interest, which is allocated to income under Section 406 of this Act, is a return of capital.

5 In consideration of the loss of value of principal due to inflation and other factors that T  
6 considers relevant, T may transfer part of the interest to principal.  
7

8 **Example (3)** – T is the trustee of a trust that requires the income to be paid to the settlor’s  
9 sister E for life, remainder to charity F. E is a retired schoolteacher who is single and has  
10 no children. E’s income from her social security, pension, and savings exceeds the  
11 amount required to provide for her accustomed standard of living. The terms of the trust  
12 permit T to invade principal to provide for E’s health and to support her in her  
13 accustomed manner of living, but do not otherwise indicate that T should favor E or F.  
14 Applying the prudent investor rule, T determines that the trust assets should be invested  
15 entirely in growth stocks that produce very little dividend income. Even though it is not  
16 necessary to invade principal to maintain E’s accustomed standard of living, she is  
17 entitled to receive from the trust the degree of beneficial enjoyment normally accorded a  
18 person who is the sole income beneficiary of a trust, and T may transfer cash from  
19 principal to income to provide her with that degree of enjoyment.  
20

21 **Example (4)** – T is the trustee of a trust that is governed by the law of State X. The trust  
22 became irrevocable before State X adopted the prudent investor rule. The terms of the  
23 trust require all of the income to be paid to G for life, remainder to H, and also give T the  
24 power to invade principal for the benefit of G for “dire emergencies only.” The terms of  
25 the trust limit the aggregate amount that T can distribute to G from principal during G’s  
26 life to 6% of the trust’s value at its inception. The trust’s portfolio is invested initially  
27 50% in stocks and 50% in bonds, but after State X adopts the prudent investor rule T  
28 determines that, to achieve suitable risk and return objectives for the trust, the assets  
29 should be invested 90% in stocks and 10% in bonds. This change increases the total  
30 return from the portfolio and decreases the dividend and interest income. Thereafter,  
31 even though G does not experience a dire emergency, T may exercise the power to adjust  
32 under Section 104(a) to the extent that T determines that the adjustment is from only the  
33 capital appreciation resulting from the change in the portfolio’s asset allocation. If T is  
34 unable to determine the extent to which capital appreciation resulted from the change in  
35 asset allocation or is unable to maintain adequate records to determine the extent to which  
36 principal distributions to G for dire emergencies do not exceed the 6% limitation, T may  
37 not exercise the power to adjust. See Joel C. Dobris, *Limits on the Doctrine of Equitable*  
38 *Adjustment in Sophisticated Postmortem Tax Planning*, 66 Iowa L. Rev. 273 (1981).  
39

40 **Example (5)** – T is the trustee of a trust for the settlor’s child. The trust owns a  
41 diversified portfolio of marketable financial assets with a value of \$600,000, and is also  
42 the sole beneficiary of the settlor’s IRA, which holds a diversified portfolio of marketable  
43 financial assets with a value of \$900,000. The trust receives a distribution from the IRA  
44 that is the minimum amount required to be distributed under the Internal Revenue Code,  
45 and T allocates 10% of the distribution to income under Section 409(c) of this Act. The

1 total return on the IRA's assets exceeds the amount distributed to the trust, and the value  
2 of the IRA at the end of the year is more than its value at the beginning of the year.  
3 Relevant factors that T may consider in determining whether to exercise the power to  
4 adjust and the extent to which an adjustment should be made to comply with Section  
5 103(b) include the total return from all of the trust's assets, those owned directly as well  
6 as its interest in the IRA, the extent to which the trust will be subject to income tax on the  
7 portion of the IRA distribution that is allocated to principal, and the extent to which the  
8 income beneficiary will be subject to income tax on the amount that T distributes to the  
9 income beneficiary.

10  
11 **Example (6)** – T is the trustee of a trust whose portfolio includes a large parcel of  
12 undeveloped real estate. T pays real property taxes on the undeveloped parcel from  
13 income each year pursuant to Section 501(3). After considering the return from the trust's  
14 portfolio as a whole and other relevant factors described in Section 104(b), T may  
15 exercise the power to adjust under Section 104(a) to transfer cash from principal to  
16 income in order to distribute to the income beneficiary an amount that T considers  
17 necessary to comply with Section 103(b).

18  
19 **Example (7)** – T is the trustee of a trust whose portfolio includes an interest in a mutual  
20 fund that is sponsored by T. As the manager of the mutual fund, T charges the fund a  
21 management fee that reduces the amount available to distribute to the trust by \$2,000. If  
22 the fee had been paid directly by the trust, one-half of the fee would have been paid from  
23 income under Section 501(1) and the other one-half would have been paid from principal  
24 under Section 502(a)(1). After considering the total return from the portfolio as a whole  
25 and other relevant factors described in Section 104(b), T may exercise its power to adjust  
26 under Section 104(a) by transferring \$1,000, or half of the trust's proportionate share of  
27 the fee, from principal to income.

28  
29 14. Some assume that the authority of a trustee to convert income interests to  
30 unitrust interests – perhaps the ultimate power to “adjust” – will be added to the  
31 next version of the UPIA. If the purpose of a unitrust conversion is to make income  
32 and principal irrelevant, does such authority belong in a principal and income act? If  
33 not, where? If so, is a new section 105 the right place? Or would it fit better  
34 somewhere else?

35 In any event, Appendices A, B, and C elaborate on the issues presented by unitrust  
36 conversions. RDA

37 **SECTION 105. JUDICIAL CONTROL OF DISCRETIONARY POWER.**

38 15. Almost half the states (*e.g.*, AL, AR, CO, CT, DC, HI, ID, IA, KS, KY, MD,  
39 MO, MT, NV, NM, NY, ND, OH, OK, TN, VA) omit this section. I wonder why.  
40 The text and the comments seem reasonable, don't they? RDA

41 (a) The court may not order a fiduciary to change a decision to exercise or not to exercise



1 a discretionary power conferred by this [Act] unless it determines that the decision was an abuse  
2 of the fiduciary's discretion. A fiduciary's decision is not an abuse of discretion merely because  
3 the court would have exercised the power in a different manner or would not have exercised the  
4 power.

5 (b) The decisions to which subsection (a) applies include:

6 (1) a decision under Section 104(a) as to whether and to what extent an amount  
7 should be transferred from principal to income or from income to principal.

8 (2) a decision regarding the factors that are relevant to the trust and its  
9 beneficiaries, the extent to which the factors are relevant, and the weight, if any, to be given to  
10 those factors, in deciding whether and to what extent to exercise the discretionary power  
11 conferred by Section 104(a).

12 (c) If the court determines that a fiduciary has abused the fiduciary's discretion, the court  
13 may place the income and remainder beneficiaries in the positions they would have occupied if  
14 the discretion had not been abused, according to the following rules:

15 (1) To the extent that the abuse of discretion has resulted in no distribution to a  
16 beneficiary or in a distribution that is too small, the court shall order the fiduciary to distribute  
17 from the trust to the beneficiary an amount that the court determines will restore the beneficiary,  
18 in whole or in part, to the beneficiary's appropriate position.

19 (2) To the extent that the abuse of discretion has resulted in a distribution to a  
20 beneficiary which is too large, the court shall place the beneficiaries, the trust, or both, in whole  
21 or in part, in their appropriate positions by ordering the fiduciary to withhold an amount from one  
22 or more future distributions to the beneficiary who received the distribution that was too large or  
23 ordering that beneficiary to return some or all of the distribution to the trust.

1 (3) To the extent that the court is unable, after applying paragraphs (1) and (2), to  
2 place the beneficiaries, the trust, or both, in the positions they would have occupied if the  
3 discretion had not been abused, the court may order the fiduciary to pay an appropriate amount  
4 from its own funds to one or more of the beneficiaries or the trust or both.

5 (d) Upon [petition] by the fiduciary, the court having jurisdiction over a trust or estate  
6 shall determine whether a proposed exercise or nonexercise by the fiduciary of a discretionary  
7 power conferred by this [Act] will result in an abuse of the fiduciary’s discretion. If the petition  
8 describes the proposed exercise or nonexercise of the power and contains sufficient information  
9 to inform the beneficiaries of the reasons for the proposal, the facts upon which the fiduciary  
10 relies, and an explanation of how the income and remainder beneficiaries will be affected by the  
11 proposed exercise or nonexercise of the power, a beneficiary who challenges the proposed  
12 exercise or nonexercise has the burden of establishing that it will result in an abuse of discretion.

### 13 **Comment**

14 **General.** All of the discretionary powers in the 1997 Act are subject to the normal rules  
15 that govern a fiduciary’s exercise of discretion. Section 105 codifies those rules for purposes of  
16 the Act so that they will be readily apparent and accessible to fiduciaries, beneficiaries, their  
17 counsel and the courts if and when questions concerning such powers arise.

18  
19 Section 105 also makes clear that the normal rules governing the exercise of a fiduciary’s  
20 powers apply to the discretionary power to adjust conferred upon a trustee by Section 104(a).  
21 Discretionary provisions authorizing trustees to determine what is income and what is principal  
22 have been used in governing instruments for years; Section 2 of the 1931 Uniform Principal and  
23 Income Act recognized that practice by providing that “the person establishing the principal may  
24 himself direct the manner of ascertainment of income and principal...or grant discretion to the  
25 trustee or other person to do so...” Section 103(a)(2) also recognizes the power of a settlor to  
26 grant such discretion to the trustee. Section 105 applies to a discretionary power granted by the  
27 terms of a trust or a will as well as the power to adjust in Section 104(a).  
28

29 **Power to Adjust.** The exercise of the power to adjust is governed by a trustee’s duty of  
30 impartiality, which requires the trustee to strike an appropriate balance between the interests of  
31 the income and remainder beneficiaries. Section 103(b) expresses this duty by requiring the  
32 trustee to “administer a trust or estate impartially, based on what is fair and reasonable to all of

1 the beneficiaries, except to the extent that the terms of the trust or the will clearly manifest an  
2 intention that the fiduciary shall or may favor one or more of the beneficiaries.” Because this  
3 involves the exercise of judgment in circumstances rarely capable of perfect resolution, trustees  
4 are not expected to achieve perfection; they are, however, required to make conscious decisions  
5 in good faith and with proper motives.  
6

7 In seeking the proper balance between the interests of the beneficiaries in matters  
8 involving principal and income, a trustee’s traditional approach has been to determine the  
9 settlor’s objectives from the terms of the trust, gather the information needed to ascertain the  
10 financial circumstances of the beneficiaries, determine the extent to which the settlor’s objectives  
11 can be achieved with the resources available in the trust, and then allocate the trust’s assets  
12 between stocks and fixed-income securities in a way that will produce a particular level or range  
13 of income for the income beneficiary. The key element in this process has been to determine the  
14 appropriate level or range of income for the income beneficiary, and that will continue to be the  
15 key element in deciding whether and to what extent to exercise the discretionary power conferred  
16 by Section 104(a). If it becomes necessary for a court to determine whether an abuse of the  
17 discretionary power to adjust between principal and income has occurred, the criteria should be  
18 the same as those that courts have used in the past to determine whether a trustee has abused its  
19 discretion in allocating the trust’s assets between stocks and fixed-income securities.  
20

21 A fiduciary has broad latitude in choosing the methods and criteria to use in deciding  
22 whether and to what extent to exercise the power to adjust in order to achieve impartiality  
23 between income beneficiaries and remainder beneficiaries or the degree of partiality for one or  
24 the other that is provided for by the terms of the trust or the will. For example, in deciding what  
25 the appropriate level or range of income should be for the income beneficiary and whether to  
26 exercise the power, a trustee may use the methods employed prior to the adoption of the 1997 Act  
27 in deciding how to allocate trust assets between stocks and fixed-income securities; or may  
28 consider the amount that would be distributed each year based on a percentage of the portfolio’s  
29 value at the beginning or end of an accounting period, or the average portfolio value for several  
30 accounting periods, in a manner similar to a unitrust, and may select a percentage that the trustee  
31 believes is appropriate for this purpose and use the same percentage or different percentages in  
32 subsequent years. The trustee may also use hypothetical portfolios of marketable securities to  
33 determine an appropriate level or range of income within which a distribution might fall.  
34

35 An adjustment may be made prospectively at the beginning of an accounting period,  
36 based on a projected return or range of returns for a trust’s portfolio, or retrospectively after the  
37 fiduciary knows the total realized or unrealized return for the period; and instead of an annual  
38 adjustment, the trustee may distribute a fixed dollar amount for several years, in a manner similar  
39 to an annuity, and may change the fixed dollar amount periodically. No inference of abuse is to  
40 be drawn if a fiduciary uses different methods or criteria for the same trust from time to time, or  
41 uses different methods or criteria for different trusts for the same accounting period.  
42

43 While a trustee must consider the portfolio as a whole in deciding whether and to what  
44 extent to exercise the power to adjust, a trustee may apply different criteria in considering the  
45 portion of the portfolio that is composed of marketable securities and the portion whose market

1 value cannot be determined readily, and may take into account a beneficiary’s use or possession  
2 of a trust asset.

3  
4 Under the prudent investor rule, a trustee is to incur costs that are appropriate and  
5 reasonable in relation to the assets and the purposes of the trust, and the same consideration  
6 applies in determining whether and to what extent to exercise the power to adjust. In making  
7 investment decisions under the prudent investor rule, the trustee will have considered the  
8 purposes, terms, distribution requirements, and other circumstances of the trust for the purpose of  
9 adopting an overall investment strategy having risk and return objectives reasonably suited to the  
10 trust. A trustee is not required to duplicate that work for principal and income purposes, and in  
11 many cases the decision about whether and to what extent to exercise the power to adjust may be  
12 made at the same time as the investment decisions. To help achieve the objective of reasonable  
13 investment costs, a trustee may also adopt policies that apply to all trusts or to individual trusts or  
14 classes of trusts, based on their size or other criteria, stating whether and under what  
15 circumstances the power to adjust will be exercised and the method of making adjustments; no  
16 inference of abuse is to be drawn if a trustee adopts such policies.

17  
18 **General rule.** The first sentence of Section 105(a) is from Restatement (Second) of  
19 Trusts § 187 and Restatement (Third) of Trusts (Tentative Draft No. 2, 1999) § 50(1). The  
20 second sentence of Section 105(a) derives from Comment *e* to § 187 of the Second Restatement  
21 and Comment *b* to § 50 of the Third Restatement.

22  
23 The reference in Section 105(a) to a fiduciary’s decision to exercise or not to exercise a  
24 discretionary power underscores a fundamental precept, which is that a fiduciary has a duty to  
25 make a conscious decision about exercising or not exercising a discretionary power. Comment *b*  
26 to § 50 of the Third Restatement states:

27  
28 [A] court will intervene where the exercise of a power is left to the judgment of a trustee  
29 who improperly fails to exercise that judgment. Thus, even where a trustee has discretion  
30 whether or not to make any payments to a particular beneficiary, the court will interpose if the  
31 trustee, arbitrarily or without knowledge of or inquiry into relevant circumstances, fails to  
32 exercise the discretion.

33  
34 Section 105(b) makes clear that the rule of subsection (a) applies not only to the power  
35 conferred by Section 104(a) but also to the evaluation process required by Section 104(b) in  
36 deciding whether and to what extent to exercise the power to adjust. Under Section 104(b), a  
37 trustee is to consider all of the factors that are relevant to the trust and its beneficiaries, including,  
38 to the extent the trustee determines they are relevant, the nine factors enumerated in Section  
39 104(b). Section 104(b) derives from Section 2(c) of the Uniform Prudent Investor Act, which  
40 lists eight circumstances that a trustee shall consider, to the extent they are relevant, in investing  
41 and managing assets. The trustee’s decisions about what factors are relevant for purposes of  
42 Section 104(b) and the weight to be accorded each of the relevant factors are part of the  
43 discretionary decision-making process. As such, these decisions are not subject to change for the  
44 purpose of changing the trustee’s ultimate decision unless the court determines that there has  
45 been an abuse of discretion in determining the relevancy and weight of these factors.

1           **Remedy.** The exercise or nonexercise of a discretionary power under the Act normally  
2 affects the amount or timing of a distribution to the income or remainder beneficiaries. The  
3 primary remedy under Section 105(c) for abuse of discretion is the restoration of the beneficiaries  
4 and the trust to the positions they would have occupied if the abuse had not occurred. It draws on  
5 a basic principle of restitution that if a person pays money to someone who is not intended to  
6 receive it (and in a case to which this Act applies, not intended by the settlor to receive it in the  
7 absence of an abuse of discretion by the trustee), that person is entitled to restitution on the  
8 ground that the payee would be unjustly enriched if he were permitted to retain the payment. See  
9 Restatement of Restitution § 22 (1937). The objective is to accomplish the restoration initially  
10 by making adjustments between the beneficiaries and the trust to the extent possible; to the  
11 extent that restoration is not possible by such adjustments, a court may order the trustee to pay an  
12 amount to one or more of the beneficiaries, the trust, or both the beneficiaries and the trust. If the  
13 court determines that it is not possible in the circumstances to restore them to their appropriate  
14 positions, the court may provide other remedies appropriate to the circumstances. The approach  
15 of Section 105(c) is supported by Comment *b* to § 50 of the Third Restatement of Trusts:  
16

17           When judicial intervention is required, a court may direct the trustee to make or refrain  
18 from making certain payments; issue instructions to clarify the standards or guidelines applicable  
19 to the exercise of the power; or rescind the trustee’s payment decisions, usually directing the  
20 trustee to recover amounts improperly distributed and holding the trustee liable for failure or  
21 inability to do so....  
22

23           **Advance determinations.** Section 105(d) employs the familiar remedy of the trustee’s  
24 petition to the court for instructions. It requires the court to determine, upon a petition by the  
25 fiduciary, whether a proposed exercise or nonexercise of a discretionary power by the fiduciary of  
26 a power conferred by the Act would be an abuse of discretion under the general rule of Section  
27 105(a). If the petition contains the information prescribed in the second sentence of subsection  
28 (d), the proposed action or inaction is presumed not to result in an abuse, and a beneficiary who  
29 challenges the proposal must establish that it will.  
30

31           Subsection (d) is intended to provide a fiduciary the opportunity to obtain an assurance of  
32 finality in a judicial proceeding before proceeding with a proposed exercise or nonexercise of a  
33 discretionary power. Its purpose is not, however, to have the court instruct the fiduciary how to  
34 exercise the discretion.  
35

36           A fiduciary may also obtain the consent of the beneficiaries to a proposed act or an  
37 omission to act, and a beneficiary cannot hold the fiduciary liable for that act or omission unless:  
38

39           (a) the beneficiary was under an incapacity at the time of such consent or of such act or  
40 omission; or  
41

42           (b) the beneficiary, when he gave his consent, did not know of his rights and of the  
43 material facts which the trustee knew or should have known and which the trustee did not  
44 reasonably believe that the beneficiary knew; or  
45

1 (c) the consent of the beneficiary was induced by improper conduct of the trustee.

2  
3 *Restatement (Second) of Trusts § 216.*  
4

5 If there are many beneficiaries, including some who are incapacitated or unascertained,  
6 the fiduciary may prefer the greater assurance of finality provided by a judicial proceeding that  
7 will bind all persons who have an interest in the trust.  
8

9 **[ARTICLE] 2**

10 **DECEDENT'S ESTATE OR TERMINATING INCOME INTEREST**

11 **SECTION 201. DETERMINATION AND DISTRIBUTION OF NET INCOME.**

12 After a decedent dies, in the case of an estate, or after an income interest in a trust ends, the  
13 following rules apply:

14 (1) A fiduciary of an estate or of a terminating income interest shall determine the  
15 amount of net income and net principal receipts received from property specifically given to a  
16 beneficiary under the rules in [Articles] 3 through 5 which apply to trustees and the rules in  
17 paragraph (5). The fiduciary shall distribute the net income and net principal receipts to the  
18 beneficiary who is to receive the specific property.

19 (2) A fiduciary shall determine the remaining net income of a decedent's estate or a  
20 terminating income interest under the rules in [Articles] 3 through 5 which apply to trustees and  
21 by:

22 (A) including in net income all income from property used to discharge liabilities;

23 (B) paying from income or principal, in the fiduciary's discretion, fees of  
24 attorneys, accountants, and fiduciaries; court costs and other expenses of administration; and  
25 interest on death taxes, but the fiduciary may pay those expenses from income of property  
26 passing to a trust for which the fiduciary claims an estate tax marital or charitable deduction only  
27 to the extent that the payment of those expenses from income will not cause the reduction or loss

1 of the deduction; and

2 16. Notice that the Act and Comments are not shy about protecting tax benefits.  
3 (We saw the same thing in section 19 of the new Uniform Trust Decanting Act.)  
4 RDA

5 (C) paying from principal all other disbursements made or incurred in connection  
6 with the settlement of a decedent's estate or the winding up of a terminating income interest,  
7 including debts, funeral expenses, disposition of remains, family allowances, and death taxes and  
8 related penalties that are apportioned to the estate or terminating income interest by the will, the  
9 terms of the trust, or applicable law.

10 (3) A fiduciary shall distribute to a beneficiary who receives a pecuniary amount outright  
11 the interest or any other amount provided by the will, the terms of the trust, or applicable law  
12 from net income determined under paragraph (2) or from principal to the extent that net income  
13 is insufficient. If a beneficiary is to receive a pecuniary amount outright from a trust after an  
14 income interest ends and no interest or other amount is provided for by the terms of the trust or  
15 applicable law, the fiduciary shall distribute the interest or other amount to which the beneficiary  
16 would be entitled under applicable law if the pecuniary amount were required to be paid under a  
17 will.

18 (4) A fiduciary shall distribute the net income remaining after distributions required by  
19 paragraph (3) in the manner described in Section 202 to all other beneficiaries, including a  
20 beneficiary who receives a pecuniary amount in trust, even if the beneficiary holds an unqualified  
21 power to withdraw assets from the trust or other presently exercisable general power of  
22 appointment over the trust.

23 (5) A fiduciary may not reduce principal or income receipts from property described in  
24 paragraph (1) because of a payment described in Section 501 or 502 to the extent that the will,

1 the terms of the trust, or applicable law requires the fiduciary to make the payment from assets  
2 other than the property or to the extent that the fiduciary recovers or expects to recover the  
3 payment from a third party. The net income and principal receipts from the property are  
4 determined by including all of the amounts the fiduciary receives or pays with respect to the  
5 property, whether those amounts accrued or became due before, on, or after the date of a  
6 decedent's death or an income interest's terminating event, and by making a reasonable provision  
7 for amounts that the fiduciary believes the estate or terminating income interest may become  
8 obligated to pay after the property is distributed.

9 **Comment**

10 **Terminating income interests and successive income interests.** A trust that provides  
11 for a single income beneficiary and an outright distribution of the remainder ends when the  
12 income interest ends. A more complex trust may have a number of income interests, either  
13 concurrent or successive, and the trust will not necessarily end when one of the income interests  
14 ends. For that reason, the Act speaks in terms of income interests ending and beginning rather  
15 than trusts ending and beginning. When an income interest in a trust ends, the trustee's powers  
16 continue during the winding up period required to complete its administration. A terminating  
17 income interest is one that has ended but whose administration is not complete.

18  
19 If two or more people are given the right to receive specified percentages or fractions of  
20 the income from a trust concurrently and one of the concurrent interests ends, e.g., when a  
21 beneficiary dies, the beneficiary's income interest ends but the trust does not. Similarly, when a  
22 trust with only one income beneficiary ends upon the beneficiary's death, the trust instrument  
23 may provide that part or all of the trust assets shall continue in trust for another income  
24 beneficiary. While it is common to think and speak of this (and even to characterize it in a trust  
25 instrument) as a "new" trust, it is a continuation of the original trust for a remainder beneficiary  
26 who has an income interest in the trust assets instead of the right to receive them outright. For  
27 purposes of this Act, this is a successive income interest in the same trust. The fact that a trust  
28 may or may not end when an income interest ends is not significant for purposes of this Act.

29  
30 If the assets that are subject to a terminating income interest pass to another trust because  
31 the income beneficiary exercises a general power of appointment over the trust assets, the  
32 recipient trust would be a new trust; and if they pass to another trust because the beneficiary  
33 exercises a nongeneral power of appointment over the trust assets, the recipient trust might be a  
34 new trust in some States (see 5A Austin W. Scott & William F. Fratcher, *The Law of Trusts* §  
35 640, at 483 (4th ed. 1989)); but for purposes of this Act a new trust created in these  
36 circumstances is also a successive income interest.



1           **Gift of a pecuniary amount.** Section 201(3) and (4) provide different rules for an  
2 outright gift of a pecuniary amount and a gift in trust of a pecuniary amount; this is the same  
3 approach used in Section 5(b)(2) of the 1962 Act.  
4

5           **Interest on pecuniary amounts.** Section 201(3) provides that the beneficiary of an  
6 outright pecuniary amount is to receive the interest or other amount provided by applicable law if  
7 there is no provision in the will or the terms of the trust. Many States have no applicable law that  
8 provides for interest or some other amount to be paid on an outright pecuniary gift under an inter  
9 vivos trust; this section provides that in such a case the interest or other amount to be paid shall  
10 be the same as the interest or other amount required to be paid on testamentary pecuniary gifts.  
11 This provision is intended to accord gifts under inter vivos instruments the same treatment as  
12 testamentary gifts. The various state authorities that provide for the amount that a beneficiary of  
13 an outright pecuniary amount is entitled to receive are collected in Richard B. Covey, *Marital*  
14 *Deduction and Credit Shelter Dispositions and the Use of Formula Provisions*, App. B (4th ed.  
15 1997).  
16

17           **Administration expenses and interest on death taxes.** Under Section 201(2)(B) a  
18 fiduciary may pay administration expenses and interest on death taxes from either income or  
19 principal. An advantage of permitting the fiduciary to choose the source of the payment is that, if  
20 the fiduciary's decision is consistent with the decision to deduct these expenses for income tax  
21 purposes or estate tax purposes, it eliminates the need to adjust between principal and income  
22 that may arise when, for example, an expense that is paid from principal is deducted for income  
23 tax purposes or an expense that is paid from income is deducted for estate tax purposes.  
24

25           The United States Supreme Court has considered the question of whether an estate tax  
26 marital deduction or charitable deduction should be reduced when administration expenses are  
27 paid from income produced by property passing in trust for a surviving spouse or for charity and  
28 deducted for income tax purposes. The Court rejected the IRS position that administration  
29 expenses properly paid from income under the terms of the trust or state law must reduce the  
30 amount of a marital or charitable transfer, and held that the value of the transferred property is  
31 not reduced for estate tax purposes unless the administration expenses are material in light of the  
32 income the trust corpus could have been expected to generate. *Commissioner v. Estate of Otis C.*  
33 *Hubert*, 117 S.Ct. 1124 (1997). The provision in Section 201(2)(B) permits a fiduciary to pay  
34 and deduct administration expenses from income only to the extent that it will not cause the  
35 reduction or loss of an estate tax marital or charitable contributions deduction, which means that  
36 the limit on the amount payable from income will be established eventually by Treasury  
37 Regulations.  
38

39           **Interest on estate taxes.** The IRS agrees that interest on estate and inheritance taxes may  
40 be deducted for income tax purposes without having to reduce the estate tax deduction for  
41 amounts passing to a charity or surviving spouse, whether the interest is paid from principal or  
42 income. Rev. Rul. 93-48, 93-2 C.B. 270. For estates of persons who died before 1998, a  
43 fiduciary may not want to deduct for income tax purposes interest on estate tax that is deferred  
44 under Section 6166 or 6163 because deducting that interest for estate tax purposes may produce  
45 more beneficial results, especially if the estate has little or no income or the income tax bracket is

1 significantly lower than the estate tax bracket. For estates of persons who die after 1997, no  
2 estate tax or income tax deduction will be allowed for interest paid on estate tax that is deferred  
3 under Section 6166. However, interest on estate tax deferred under Section 6163 will continue to  
4 be deductible for both purposes, and interest on estate tax deficiencies will continue to be  
5 deductible for estate tax purposes if an election under Section 6166 is not in effect.  
6

7 17. Perhaps this statement should be limited to “*federal* estate tax or income tax  
8 deduction”. Are there other federal rules the Act and Comments should be concerned  
9 about? RDA

10 Under the 1962 Act, Section 13(c)(5) charges interest on estate and inheritance taxes to  
11 principal. The 1931 Act has no provision. Section 501(3) of this Act provides that, except to the  
12 extent provided in Section 201(2)(B) or (C), all interest must be paid from income.  
13

## 14 **SECTION 202. DISTRIBUTION TO RESIDUARY AND REMAINDER**

### 15 **BENEFICIARIES.**

16 (a) Each beneficiary described in Section 201(4) is entitled to receive a portion of the net  
17 income equal to the beneficiary’s fractional interest in undistributed principal assets, using values  
18 as of the distribution date. If a fiduciary makes more than one distribution of assets to  
19 beneficiaries to whom this section applies, each beneficiary, including one who does not receive  
20 part of the distribution, is entitled, as of each distribution date, to the net income the fiduciary has  
21 received after the date of death or terminating event or earlier distribution date but has not  
22 distributed as of the current distribution date.

23 (b) In determining a beneficiary’s share of net income, the following rules apply:

24 (1) The beneficiary is entitled to receive a portion of the net income equal to the  
25 beneficiary’s fractional interest in the undistributed principal assets immediately before the  
26 distribution date, including assets that later may be sold to meet principal obligations.

27 (2) The beneficiary’s fractional interest in the undistributed principal assets must  
28 be calculated without regard to property specifically given to a beneficiary and property required  
29 to pay pecuniary amounts not in trust.

1 (3) The beneficiary's fractional interest in the undistributed principal assets must  
2 be calculated on the basis of the aggregate value of those assets as of the distribution date without  
3 reducing the value by any unpaid principal obligation.

4 (4) The distribution date for purposes of this section may be the date as of which  
5 the fiduciary calculates the value of the assets if that date is reasonably near the date on which  
6 assets are actually distributed.

7 (c) If a fiduciary does not distribute all of the collected but undistributed net income to  
8 each person as of a distribution date, the fiduciary shall maintain appropriate records showing the  
9 interest of each beneficiary in that net income.

10 (d) A fiduciary may apply the rules in this section, to the extent that the fiduciary  
11 considers it appropriate, to net gain or loss realized after the date of death or terminating event or  
12 earlier distribution date from the disposition of a principal asset if this section applies to the  
13 income from the asset.

#### 14 **Comment**

15 **Relationship to prior Acts.** Section 202 retains the concept in Section 5(b)(2) of the  
16 1962 Act that the residuary legatees of estates are to receive net income earned during the period  
17 of administration on the basis of their proportionate interests in the undistributed assets when  
18 distributions are made. It changes the basis for determining their proportionate interests by using  
19 asset values as of a date reasonably near the time of distribution instead of inventory values; it  
20 extends the application of these rules to distributions from terminating trusts; and it extends these  
21 rules to gain or loss realized from the disposition of assets during administration, an omission in  
22 the 1962 Act that has been noted by several commentators. See, e.g., Richard B. Covey, *Marital*  
23 *Deduction and Credit Shelter Dispositions and the Use of Formula Provisions* 91 (4th ed. 1998);  
24 Thomas H. Cantrill, *Fractional or Percentage Residuary Bequests: Allocation of Postmortem*  
25 *Income, Gain and Unrealized Appreciation*, 10 *Prob. Notes* 322, 327 (1985).

1 [ARTICLE] 3

2 APPORTIONMENT AT BEGINNING AND END OF INCOME INTEREST

3 SECTION 301. WHEN RIGHT TO INCOME BEGINS AND ENDS.

4 (a) An income beneficiary is entitled to net income from the date on which the income  
5 interest begins. An income interest begins on the date specified in the terms of the trust or, if no  
6 date is specified, on the date an asset becomes subject to a trust or successive income interest.

7 (b) An asset becomes subject to a trust:

8 (1) on the date it is transferred to the trust in the case of an asset that is transferred  
9 to a trust during the transferor's life;

10 (2) on the date of a testator's death in the case of an asset that becomes subject to  
11 a trust by reason of a will, even if there is an intervening period of administration of the testator's  
12 estate; or

13 (3) on the date of an individual's death in the case of an asset that is transferred to  
14 a fiduciary by a third party because of the individual's death.

15 (c) An asset becomes subject to a successive income interest on the day after the  
16 preceding income interest ends, as determined under subsection (d), even if there is an  
17 intervening period of administration to wind up the preceding income interest.

18 (d) An income interest ends on the day before an income beneficiary dies or another  
19 terminating event occurs, or on the last day of a period during which there is no beneficiary to  
20 whom a trustee may distribute income.

21 **Comment**

22 **Period during which there is no beneficiary.** The purpose of the second part of  
23 subsection (d) is to provide that, at the end of a period during which there is no beneficiary to  
24 whom a trustee may distribute income, the trustee must apply the same apportionment rules that

1 apply when a mandatory income interest ends. This provision would apply, for example, if a  
2 settlor creates a trust for grandchildren before any grandchildren are born. When the first  
3 grandchild is born, the period preceding the date of birth is treated as having ended, followed by  
4 a successive income interest, and the apportionment rules in Sections 302 and 303 apply  
5 accordingly if the terms of the trust do not contain different provisions.  
6

7 **SECTION 302. APPORTIONMENT OF RECEIPTS AND DISBURSEMENTS**

8 **WHEN DECEDENT DIES OR INCOME INTEREST BEGINS.**

9 (a) A trustee shall allocate an income receipt or disbursement other than one to which  
10 Section 201(1) applies to principal if its due date occurs before a decedent dies in the case of an  
11 estate or before an income interest begins in the case of a trust or successive income interest.

12 18. Should “before a decedent dies” be changed to “before the date on which a  
13 decedent dies” so as to coincide with the formulation in subsection (b) and eliminate  
14 the significance of the time of day at which the decedent dies? Is that always a good  
15 idea, though? List-serves have good berserk over this notion of when death occurs  
16 for income tax purposes. RDA

17 (b) A trustee shall allocate an income receipt or disbursement to income if its due date  
18 occurs on or after the date on which a decedent dies or an income interest begins and it is a  
19 periodic due date. An income receipt or disbursement must be treated as accruing from day to  
20 day if its due date is not periodic or it has no due date. The portion of the receipt or disbursement  
21 accruing before the date on which a decedent dies or an income interest begins must be allocated  
22 to principal and the balance must be allocated to income.

23 19. Again, is elimination of the significance of the time of day at which the  
24 decedent dies always a good idea? If not, how can a workable line possibly be  
25 drawn? And what about time zones? There must be other areas of the law, perhaps  
26 even other Uniform Acts, in which this comes up frequently. RDA

27 (c) An item of income or an obligation is due on the date the payer is required to make a  
28 payment. If a payment date is not stated, there is no due date for the purposes of this [Act].  
29 Distributions to shareholders or other owners from an entity to which Section 401 applies are

1 deemed to be due on the date fixed by the entity for determining who is entitled to receive the  
2 distribution or, if no date is fixed, on the declaration date for the distribution. A due date is  
3 periodic for receipts or disbursements that must be paid at regular intervals under a lease or an  
4 obligation to pay interest or if an entity customarily makes distributions at regular intervals.

### 5 **Comment**

6 **Prior Acts.** Professor Bogert stated that “Section 4 of the [1962] Act makes a change  
7 with respect to the apportionment of the income of trust property not due until after the trust  
8 began but which accrued in part before the commencement of the trust. It treats such income as  
9 to be credited entirely to the income account in the case of a living trust, but to be apportioned  
10 between capital and income in the case of a testamentary trust. The [1931] Act apportions such  
11 income in the case of both types of trusts, except in the case of corporate dividends.” George G.  
12 Bogert, *The Revised Uniform Principal and Income Act*, 38 *Notre Dame Law* 50, 52 (1962).  
13 The 1962 Act also provides that an asset passing to an inter vivos trust by a bequest in the  
14 settlor’s will is governed by the rule that applies to a testamentary trust, so that different rules  
15 apply to assets passing to an inter vivos trust depending upon whether they were transferred to  
16 the trust during the settlor’s life or by his will.

17  
18 Having several different rules that apply to similar transactions is confusing. In order to  
19 simplify administration, Section 302 applies the same rule to inter vivos trusts (revocable and  
20 irrevocable), testamentary trusts, and assets that become subject to an inter vivos trust by a  
21 testamentary bequest.

22  
23 **Periodic payments.** Under Section 302, a periodic payment is principal if it is due but  
24 unpaid before a decedent dies or before an asset becomes subject to a trust, but the next payment  
25 is allocated entirely to income and is not apportioned. Thus, periodic receipts such as rents,  
26 dividends, interest, and annuities, and disbursements such as the interest portion of a mortgage  
27 payment, are not apportioned. This is the original common law rule. Edwin A. Howes, Jr., *The*  
28 *American Law Relating to Income and Principal* 70 (1905). In trusts in which a surviving spouse  
29 is dependent upon a regular flow of cash from the decedent’s securities portfolio, this rule will  
30 help to maintain payments to the spouse at the same level as before the settlor’s death. Under the  
31 1962 Act, the pre-death portion of the first periodic payment due after death is apportioned to  
32 principal in the case of a testamentary trust or securities bequeathed by will to an inter vivos  
33 trust.

34  
35 **Nonperiodic payments.** Under the second sentence of Section 302(b), interest on an  
36 obligation that does not provide a due date for the interest payment, such as interest on an income  
37 tax refund, would be apportioned to principal to the extent it accrues before a person dies or an  
38 income interest begins unless the obligation is specifically given to a devisee or remainder  
39 beneficiary, in which case all of the accrued interest passes under Section 201(1) to the person  
40 who receives the obligation. The same rule applies to interest on an obligation that has a due

1 date but does not provide for periodic payments. If there is no stated interest on the obligation,  
2 such as a zero coupon bond, and the proceeds from the obligation are received more than one  
3 year after it is purchased or acquired by the trustee, the entire amount received is principal under  
4 Section 406.

5  
6 **SECTION 303. APPORTIONMENT WHEN INCOME INTEREST ENDS.**

7 (a) In this section, “undistributed income” means net income received before the date on  
8 which an income interest ends. The term does not include an item of income or expense that is  
9 due or accrued or net income that has been added or is required to be added to principal under the  
10 terms of the trust.

11 (b) When a mandatory income interest ends, the trustee shall pay to a mandatory income  
12 beneficiary who survives that date, or the estate of a deceased mandatory income beneficiary  
13 whose death causes the interest to end, the beneficiary’s share of the undistributed income that is  
14 not disposed of under the terms of the trust unless the beneficiary has an unqualified power to  
15 revoke more than five percent of the trust immediately before the income interest ends. In the  
16 latter case, the undistributed income from the portion of the trust that may be revoked must be  
17 added to principal.

18 (c) When a trustee’s obligation to pay a fixed annuity or a fixed fraction of the value of  
19 the trust’s assets ends, the trustee shall prorate the final payment if and to the extent required by  
20 applicable law to accomplish a purpose of the trust or its settlor relating to income, gift, estate, or  
21 other tax requirements.

22 **Comment**

23 **Prior Acts.** Both the 1931 Act (Section 4) and the 1962 Act (Section 4(d)) provide that a  
24 deceased income beneficiary’s estate is entitled to the undistributed income. The Drafting  
25 Committee concluded that this is probably not what most settlors would want, and that, with  
26 respect to undistributed income, most settlors would favor the income beneficiary first, the  
27 remainder beneficiaries second, and the income beneficiary’s heirs last, if at all. However, it  
28 decided not to eliminate this provision to avoid causing disputes about whether the trustee should

1 have distributed collected cash before the income beneficiary died.

2  
3 20. Should we revisit this? I don't believe any state has "taken the bait" and  
4 eliminated this estate rule. The concern about creating pressure to distribute at  
5 frequent intervals seems legitimate. Moreover, the estate rule probably accords best  
6 with the paradigm of a beneficiary accruing bills, like credit card charges and  
7 unreimbursed medical expenses, that are paid in arrears from trust distributions. At  
8 the other end of the wealth spectrum, payment to the estate might create an avoidable  
9 increment of estate tax. May we assume that those situations typically entail more  
10 sophisticated estate planning that can draft around that? The disposition of "stub  
11 income" has also produced controversy in the context of the federal estate tax marital  
12 deduction, where the "true" answer may still be in doubt. Should the period of  
13 accumulation since the last distribution – that is, a month, a quarter, longer – matter?  
14 Would a rule based on the period be easy to craft? Would it be workable? And  
15 should we be concerned about creating a structure in which two otherwise identically  
16 situated beneficiaries are treated differently if, say, they die at different times of the  
17 month? RDA

18  
19 **Accrued periodic payments.** Under the prior Acts, an income beneficiary or his estate is  
20 entitled to receive a portion of any payments, other than dividends, that are due or that have  
21 accrued when the income interest terminates. The last sentence of subsection (a) changes that  
22 rule by providing that such items are not included in undistributed income. The items affected  
23 include periodic payments of interest, rent, and dividends, as well as items of income that accrue  
24 over a longer period of time; the rule also applies to expenses that are due or accrued.

25  
26 21. Aren't the issues with accrued income about the same as with received but  
27 undistributed income? RDA

28  
29 **Example – accrued periodic payments.** The rules in Section 302 and Section 303 work  
30 in the following manner: Assume that a periodic payment of rent that is due on July 20 has not  
31 been paid when an income interest ends on July 30; the successive income interest begins on July  
32 31, and the rent payment that was due on July 20 is paid on August 3. Under Section 302(a), the  
33 July 20 payment is added to the principal of the successive income interest when received.  
34 Under Section 302(b), the entire periodic payment of rent that is due on August 20 is income  
35 when received by the successive income interest. Under Section 303, neither the income  
36 beneficiary of the terminated income interest nor the beneficiary's estate is entitled to any part of  
37 either the July 20 or the August 20 payments because neither one was received before the income  
38 interest ended on July 30. The same principles apply to expenses of the trust.

39  
40 **Beneficiary with an unqualified power to revoke.** The requirement in subsection (b) to  
41 pay undistributed income to a mandatory income beneficiary or her estate does not apply to the  
42 extent the beneficiary has an unqualified power to revoke more than five percent of the trust  
43 immediately before the income interest ends. Without this exception, subsection (b) would apply  
44 to a revocable living trust whose settlor is the mandatory income beneficiary during her lifetime,  
45



1 even if her will provides that all of the assets in the probate estate are to be distributed to the  
2 trust.

3  
4 22. Does this include a “5-and-5 power” of withdrawal? Maybe it *primarily*  
5 means, or is targeted to, a “5-and-5 power”? If so, should the comment say so?  
6 RDA

7  
8 If a trust permits the beneficiary to withdraw all or a part of the trust principal after  
9 attaining a specified age and the beneficiary attains that age but fails to withdraw all of the  
10 principal that she is permitted to withdraw, a trustee is not required to pay her or her estate the  
11 undistributed income attributable to the portion of the principal that she left in the trust. The  
12 assumption underlying this rule is that the beneficiary has either provided for the disposition of  
13 the trust assets (including the undistributed income) by exercising a power of appointment that  
14 she has been given or has not withdrawn the assets because she is willing to have the principal  
15 and undistributed income be distributed under the terms of the trust. If the beneficiary has the  
16 power to withdraw 25% of the trust principal, the trustee must pay to her or her estate the  
17 undistributed income from the 75% that she cannot withdraw.

18  
19 **[ARTICLE] 4**

20 **ALLOCATION OF RECEIPTS DURING ADMINISTRATION OF TRUST**

21 **[PART 1**

22 **RECEIPTS FROM ENTITIES]**

23 **SECTION 401. CHARACTER OF RECEIPTS.**

24 (a) In this section, “entity” means a corporation, partnership, limited liability company,  
25 regulated investment company, real estate investment trust, common trust fund, or any other  
26 organization in which a trustee has an interest other than a trust or estate to which Section 402  
27 applies, a business or activity to which Section 403 applies, or an asset-backed security to which  
28 Section 415 applies.

29 (b) Except as otherwise provided in this section, a trustee shall allocate to income money  
30 received from an entity.

31 (c) A trustee shall allocate the following receipts from an entity to principal:

32 (1) property other than money;

- 1 (2) money received in one distribution or a series of related distributions in  
2 exchange for part or all of a trust’s interest in the entity;
- 3 (3) money received in total or partial liquidation of the entity; and
- 4 (4) money received from an entity that is a regulated investment company or a real  
5 estate investment trust if the money distributed is a capital gain dividend for federal income tax  
6 purposes.

7 23. Section 401(c)(4) seems like a very narrow special rule, aimed at certain  
8 entities and events Congress has defined to serve objectives of federal income tax  
9 policy. Is there a way to make this more generic? Is that desirable? As an  
10 illustration, or a start, Florida has replaced “is a capital gain dividend for federal  
11 income tax purposes” with “represents short-term or long-term capital gain realized  
12 within the entity.” But Florida retains the focus on regulated investment companies  
13 and real estate investment trusts. RDA

14 (d) Money is received in partial liquidation:

15 (1) to the extent that the entity, at or near the time of a distribution, indicates that  
16 it is a distribution in partial liquidation; or

17 (2) if the total amount of money and property received in a distribution or series of  
18 related distributions is greater than 20 percent of the entity’s gross assets, as shown by the entity’s  
19 year-end financial statements immediately preceding the initial receipt.

20 24. Is 20 percent realistic in a highly leveraged business? Should this be based on  
21 *net* value? In every case? How are cases distinguished? RDA

22 (e) Money is not received in partial liquidation, nor may it be taken into account under  
23 subsection (d)(2), to the extent that it does not exceed the amount of income tax that a trustee or  
24 beneficiary must pay on taxable income of the entity that distributes the money.

25 (f) A trustee may rely upon a statement made by an entity about the source or character of  
26 a distribution if the statement is made at or near the time of distribution by the entity’s board of

1 directors or other person or group of persons authorized to exercise powers to pay money or  
2 transfer property comparable to those of a corporation's board of directors.

### 3 **Comment**

4 **Entities to which Section 401 applies.** The reference to partnerships in Section 401(a) is  
5 intended to include all forms of partnerships, including limited partnerships, limited liability  
6 partnerships, and variants that have slightly different names and characteristics from State to  
7 State. The section does not apply, however, to receipts from an interest in property that a trust  
8 owns as a tenant in common with one or more co-owners, nor would it apply to an interest in a  
9 joint venture if, under applicable law, the trust's interest is regarded as that of a tenant in  
10 common.

11  
12 **Capital gain dividends.** Under the Internal Revenue Code and the Income Tax  
13 Regulations, a "capital gain dividend" from a mutual fund or real estate investment trust is the  
14 excess of the fund's or trust's net long-term capital gain over its net short-term capital loss. As a  
15 result, a capital gain dividend does not include any net short-term capital gain, and cash received  
16 by a trust because of a net short-term capital gain is income under this Act.

17  
18 **Reinvested dividends.** If a trustee elects (or continues an election made by its  
19 predecessor) to reinvest dividends in shares of stock of a distributing corporation or fund,  
20 whether evidenced by new certificates or entries on the books of the distributing entity, the new  
21 shares would be principal. Making or continuing such an election would be equivalent to  
22 deciding under Section 104 to transfer income to principal in order to comply with Section  
23 103(b). However, if the trustee makes or continues the election for a reason other than to comply  
24 with Section 103(b), e.g., to make an investment without incurring brokerage commissions, the  
25 trustee should transfer cash from principal to income in an amount equal to the reinvested  
26 dividends.

27  
28 **Distribution of property.** The 1962 Act describes a number of types of property that  
29 would be principal if distributed by a corporation. This becomes unwieldy in a section that  
30 applies to both corporations and all other entities. By stating that principal includes the  
31 distribution of any property other than money, Section 401 embraces all of the items enumerated  
32 in Section 6 of the 1962 Act as well as any other form of nonmonetary distribution not  
33 specifically mentioned in that Act.

34  
35 **Partial liquidations.** Under subsection (d)(1), any distribution designated by the entity  
36 as a partial liquidating distribution is principal regardless of the percentage of total assets that it  
37 represents. If a distribution exceeds 20% of the entity's gross assets, the entire distribution is a  
38 partial liquidation under subsection (d)(2) whether or not the entity describes it as a partial  
39 liquidation. In determining whether a distribution is greater than 20% of the gross assets, the  
40 portion of the distribution that does not exceed the amount of income tax that the trustee or a  
41 beneficiary must pay on the entity's taxable income is ignored.



1           **SECTION 403. BUSINESS AND OTHER ACTIVITIES CONDUCTED BY**  
2 **TRUSTEE.**

3           (a) If a trustee who conducts a business or other activity determines that it is in the best  
4 interest of all the beneficiaries to account separately for the business or activity instead of  
5 accounting for it as part of the trust’s general accounting records, the trustee may maintain  
6 separate accounting records for its transactions, whether or not its assets are segregated from  
7 other trust assets.

8           (b) A trustee who accounts separately for a business or other activity may determine the  
9 extent to which its net cash receipts must be retained for working capital, the acquisition or  
10 replacement of fixed assets, and other reasonably foreseeable needs of the business or activity,  
11 and the extent to which the remaining net cash receipts are accounted for as principal or income  
12 in the trust’s general accounting records. If a trustee sells assets of the business or other activity,  
13 other than in the ordinary course of the business or activity, the trustee shall account for the net  
14 amount received as principal in the trust’s general accounting records to the extent the trustee  
15 determines that the amount received is no longer required in the conduct of the business.

16           (c) Activities for which a trustee may maintain separate accounting records include:

- 17           (1) retail, manufacturing, service, and other traditional business activities;
- 18           (2) farming;
- 19           (3) raising and selling livestock and other animals;
- 20           (4) management of rental properties;
- 21           (5) extraction of minerals and other natural resources;
- 22           (6) timber operations; and
- 23           (7) activities to which Section 414 applies.

1 25. What does “separate accounting” mean, for example, in a trust the only  
2 activity of which (other than making distributions to beneficiaries) is the conduct of a  
3 business? Is it reasonable to assume that receipts not distributed to beneficiaries have  
4 been “retained” for use in the business? Does that mean that the distributions to  
5 beneficiaries in effect define trust income? Is that reasonable? In that case, what  
6 happens if distributions to multiple beneficiaries are not pro rata? If the terms of the  
7 trust require income to be distributed pro rata, but also allow distributions of  
8 principal, how can principal distributions be reconciled with the “needs of the  
9 business”? RDA

10 26. In any event, frustrations with the income and principal accounting in the case  
11 of businesses is one of the concerns I have heard most often (not a scientific survey).  
12 Perhaps representatives of corporate fiduciaries can provide useful input here. RDA

### 13 Comment

14 **Purpose and scope.** The provisions in Section 403 are intended to give greater flexibility  
15 to a trustee who operates a business or other activity in proprietorship form rather than in a  
16 wholly-owned corporation (or, where permitted by state law, a single-member limited liability  
17 company), and to facilitate the trustee’s ability to decide the extent to which the net receipts from  
18 the activity should be allocated to income, just as the board of directors of a corporation owned  
19 entirely by the trust would decide the amount of the annual dividend to be paid to the trust. It  
20 permits a trustee to account for farming or livestock operations, rental properties, oil and gas  
21 properties, timber operations, and activities in derivatives and options as though they were held  
22 by a separate entity. It is not intended, however, to permit a trustee to account separately for a  
23 traditional securities portfolio to avoid the provisions of this Act that apply to such securities.  
24

25 Section 403 permits the trustee to account separately for each business or activity for  
26 which the trustee determines separate accounting is appropriate. A trustee with a computerized  
27 accounting system may account for these activities in a “subtrust”; an individual trustee may  
28 continue to use the business and record-keeping methods employed by the decedent or transferor  
29 who may have conducted the business under an assumed name. The intent of this section is to  
30 give the trustee broad authority to select business record-keeping methods that best suit the  
31 activity in which the trustee is engaged.  
32

33 If a fiduciary liquidates a sole proprietorship or other activity to which Section 403  
34 applies, the proceeds would be added to principal, even though derived from the liquidation of  
35 accounts receivable, because the proceeds would no longer be needed in the conduct of the  
36 business. If the liquidation occurs during probate or during an income interest’s winding up  
37 period, none of the proceeds would be income for purposes of Section 201.  
38

39 **Separate accounts.** A trustee may or may not maintain separate bank accounts for  
40 business activities that are accounted for under Section 403. A professional trustee may decide  
41 not to maintain separate bank accounts, but an individual trustee, especially one who has  
42 continued a decedent’s business practices, may continue the same banking arrangements that

1 were used during the decedent's lifetime. In either case, the trustee is authorized to decide to  
2 what extent cash is to be retained as part of the business assets and to what extent it is to be  
3 transferred to the trust's general accounts, either as income or principal.  
4

5 **[PART 2**

6 **RECEIPTS NOT NORMALLY APPORTIONED]**

7 **SECTION 404. PRINCIPAL RECEIPTS.** A trustee shall allocate to principal:

8 (1) to the extent not allocated to income under this [Act], assets received from a transferor  
9 during the transferor's lifetime, a decedent's estate, a trust with a terminating income interest, or  
10 a payer under a contract naming the trust or its trustee as beneficiary;

11 (2) money or other property received from the sale, exchange, liquidation, or change in  
12 form of a principal asset, including realized profit, subject to this [article];

13 (3) amounts recovered from third parties to reimburse the trust because of disbursements  
14 described in Section 502(a)(7) or for other reasons to the extent not based on the loss of income;

15 (4) proceeds of property taken by eminent domain, but a separate award made for the loss  
16 of income with respect to an accounting period during which a current income beneficiary had a  
17 mandatory income interest is income;

18 (5) net income received in an accounting period during which there is no beneficiary to  
19 whom a trustee may or must distribute income; and

20 (6) other receipts as provided in [Part 3].

21 **Comment**

22 **Eminent domain awards.** Even though the award in an eminent domain proceeding  
23 may include an amount for the loss of future rent on a lease, if that amount is not separately  
24 stated the entire award is principal. The rule is the same in the 1931 and 1962 Acts.  
25

26 **SECTION 405. RENTAL PROPERTY.** To the extent that a trustee accounts for  
27 receipts from rental property pursuant to this section, the trustee shall allocate to income an

1 amount received as rent of real or personal property, including an amount received for  
2 cancellation or renewal of a lease. An amount received as a refundable deposit, including a  
3 security deposit or a deposit that is to be applied as rent for future periods, must be added to  
4 principal and held subject to the terms of the lease and is not available for distribution to a  
5 beneficiary until the trustee’s contractual obligations have been satisfied with respect to that  
6 amount.

7 **Comment**

8 **Application of Section 403.** This section applies to the extent that the trustee does not  
9 account separately under Section 403 for the management of rental properties owned by the trust.

10  
11 **Receipts that are capital in nature.** A portion of the payment under a lease may be a  
12 reimbursement of principal expenditures for improvements to the leased property that is  
13 characterized as rent for purposes of invoking contractual or statutory remedies for nonpayment.  
14 If the trustee is accounting for rental income under Section 405, a transfer from income to  
15 reimburse principal may be appropriate under Section 504 to the extent that some of the “rent” is  
16 really a reimbursement for improvements. This set of facts could also be a relevant factor for a  
17 trustee to consider under Section 104(b) in deciding whether and to what extent to make an  
18 adjustment between principal and income under Section 104(a) after considering the return from  
19 the portfolio as a whole.

20  
21 **SECTION 406. OBLIGATION TO PAY MONEY.**

22 (a) An amount received as interest, whether determined at a fixed, variable, or floating  
23 rate, on an obligation to pay money to the trustee, including an amount received as consideration  
24 for prepaying principal, must be allocated to income without any provision for amortization of  
25 premium.

26 (b) A trustee shall allocate to principal an amount received from the sale, redemption, or  
27 other disposition of an obligation to pay money to the trustee more than one year after it is  
28 purchased or acquired by the trustee, including an obligation whose purchase price or value when  
29 it is acquired is less than its value at maturity. If the obligation matures within one year after it is



1 purchased or acquired by the trustee, an amount received in excess of its purchase price or its  
2 value when acquired by the trust must be allocated to income.

3 (c) This section does not apply to an obligation to which Section 409, 410, 411, 412, 414,  
4 or 415 applies.

### 5 **Comment**

6 **Variable or floating interest rates.** The reference in subsection (a) to variable or  
7 floating interest rate obligations is intended to clarify that, even though an obligation's interest  
8 rate may change from time to time based upon changes in an index or other market indicator, an  
9 obligation to pay money containing a variable or floating rate provision is subject to this section  
10 and is not to be treated as a derivative financial instrument under Section 414.

11  
12 **Discount obligations.** Subsection (b) applies to all obligations acquired at a discount,  
13 including short-term obligations such as U.S. Treasury Bills, long-term obligations such as U.S.  
14 Savings Bonds, zero-coupon bonds, and discount bonds that pay interest during part, but not all,  
15 of the period before maturity. Under subsection (b), the entire increase in value of these  
16 obligations is principal when the trustee receives the proceeds from the disposition unless the  
17 obligation, when acquired, has a maturity of less than one year. In order to have one rule that  
18 applies to all discount obligations, the Act eliminates the provision in the 1962 Act for the  
19 payment from principal of an amount equal to the increase in the value of U.S. Series E bonds.  
20 The provision for bonds that mature within one year after acquisition by the trustee is derived  
21 from the Illinois act. 760 ILCS 15/8 (1996).

22  
23 Subsection (b) also applies to inflation-indexed bonds - any increase in principal due to  
24 inflation after issuance is principal upon redemption if the bond matures more than one year after  
25 the trustee acquires it; if it matures within one year, all of the increase, including any attributable  
26 to an inflation adjustment, is income.

27  
28 **Effect of Section 104.** In deciding whether and to what extent to exercise the power to  
29 adjust between principal and income granted by Section 104(a), a relevant factor for the trustee to  
30 consider is the effect on the portfolio as a whole of having a portion of the assets invested in  
31 bonds that do not pay interest currently.

### 32 **SECTION 407. INSURANCE POLICIES AND SIMILAR CONTRACTS.**

33  
34 (a) Except as otherwise provided in subsection (b), a trustee shall allocate to principal the  
35 proceeds of a life insurance policy or other contract in which the trust or its trustee is named as  
36 beneficiary, including a contract that insures the trust or its trustee against loss for damage to,

1 destruction of, or loss of title to a trust asset. The trustee shall allocate dividends on an insurance  
2 policy to income if the premiums on the policy are paid from income, and to principal if the  
3 premiums are paid from principal.

4 (b) A trustee shall allocate to income proceeds of a contract that insures the trustee  
5 against loss of occupancy or other use by an income beneficiary, loss of income, or, subject to  
6 Section 403, loss of profits from a business.

7 (c) This section does not apply to a contract to which Section 409 applies.

8 **[PART 3**

9 **RECEIPTS NORMALLY APPORTIONED]**

10 **SECTION 408. INSUBSTANTIAL ALLOCATIONS NOT REQUIRED.** If a trustee  
11 determines that an allocation between principal and income required by Section 409, 410, 411,  
12 412, or 415 is insubstantial, the trustee may allocate the entire amount to principal unless one of  
13 the circumstances described in Section 104(c) applies to the allocation. This power may be  
14 exercised by a cotrustee in the circumstances described in Section 104(d) and may be released for  
15 the reasons and in the manner described in Section 104(e). An allocation is presumed to be  
16 insubstantial if:

17 (1) the amount of the allocation would increase or decrease net income in an accounting  
18 period, as determined before the allocation, by less than 10 percent; or

19 (2) the value of the asset producing the receipt for which the allocation would be made is  
20 less than 10 percent of the total value of the trust's assets at the beginning of the accounting  
21 period.

22 **Comment**

23 This section is intended to relieve a trustee from making relatively small allocations while

1 preserving the trustee’s right to do so if an allocation is large in terms of absolute dollars.

2  
3 For example, assume that a trust’s assets, which include a working interest in an oil well,  
4 have a value of \$1,000,000; the net income from the assets other than the working interest is  
5 \$40,000; and the net receipts from the working interest are \$400. The trustee may allocate all of  
6 the net receipts from the working interest to principal instead of allocating 10%, or \$40, to  
7 income under Section 411. If the net receipts from the working interest are \$35,000, so that the  
8 amount allocated to income under Section 411 would be \$3,500, the trustee may decide that this  
9 amount is sufficiently significant to the income beneficiary that the allocation provided for by  
10 Section 411 should be made, even though the trustee is still permitted under Section 408 to  
11 allocate all of the net receipts to principal because the \$3,500 would increase the net income of  
12 \$40,000, as determined before making an allocation under Section 411, by less than 10%.  
13 Section 408 will also relieve a trustee from having to allocate net receipts from the sale of trees  
14 in a small woodlot between principal and income.

15  
16 While the allocation to principal of small amounts under this section should not be a  
17 cause for concern for tax purposes, allocations are not permitted under this section in  
18 circumstances described in Section 104(c) to eliminate claims that the power in this section has  
19 adverse tax consequences.

20  
21 **SECTION 409. DEFERRED COMPENSATION, ANNUITIES, AND SIMILAR**

22 **PAYMENTS.**

23 27. This is part of the 2008 revisions, reacting to Revenue Ruling 2006-26, 2006-  
24 22 I.R.B. 939. RDA

25 (a) In this section:

26 (1) “Payment” means a payment that a trustee may receive over a fixed number of  
27 years or during the life of one or more individuals because of services rendered or property  
28 transferred to the payer in exchange for future payments. The term includes a payment made in  
29 money or property from the payer’s general assets or from a separate fund created by the payer.  
30 For purposes of subsections (d), (e), (f), and (g), the term also includes any payment from any  
31 separate fund, regardless of the reason for the payment.

32 (2) “Separate fund” includes a private or commercial annuity, an individual  
33 retirement account, and a pension, profit-sharing, stock-bonus, or stock-ownership plan.

1 (b) To the extent that a payment is characterized as interest, a dividend, or a payment  
2 made in lieu of interest or a dividend, a trustee shall allocate the payment to income. The trustee  
3 shall allocate to principal the balance of the payment and any other payment received in the same  
4 accounting period that is not characterized as interest, a dividend, or an equivalent payment.

5 (c) If no part of a payment is characterized as interest, a dividend, or an equivalent  
6 payment, and all or part of the payment is required to be made, a trustee shall allocate to income  
7 10 percent of the part that is required to be made during the accounting period and the balance to  
8 principal. If no part of a payment is required to be made or the payment received is the entire  
9 amount to which the trustee is entitled, the trustee shall allocate the entire payment to principal.  
10 For purposes of this subsection, a payment is not required to be made to the extent that it is made  
11 because the trustee exercises a right of withdrawal.

12 (d) Except as otherwise provided in subsection (e), subsections (f) and (g) apply, and  
13 subsections (b) and (c) do not apply, in determining the allocation of a payment made from a  
14 separate fund to:

15 (1) a trust to which an election to qualify for a marital deduction under Section  
16 2056(b)(7) of the Internal Revenue Code of 1986 [, as amended] [, 26 U.S.C. Section 2056(b)(7)]  
17 [, as amended], has been made; or

18 (2) a trust that qualifies for the marital deduction under Section 2056(b)(5) of the  
19 Internal Revenue Code of 1986 [, as amended] [, 26 U.S.C. Section 2056(b)(5)] [, as amended].

20 (e) Subsections (d), (f), and (g) do not apply if and to the extent that the series of  
21 payments would, without the application of subsection (d), qualify for the marital deduction  
22 under Section 2056(b)(7)(C) of the Internal Revenue Code of 1986 [, as amended] [, 26 U.S.C.  
23 Section 2056(b)(7)(C)] [, as amended].

1 (f) A trustee shall determine the internal income of each separate fund for the accounting  
2 period as if the separate fund were a trust subject to this [act]. Upon request of the surviving  
3 spouse, the trustee shall demand that the person administering the separate fund distribute the  
4 internal income to the trust. The trustee shall allocate a payment from the separate fund to  
5 income to the extent of the internal income of the separate fund and distribute that amount to the  
6 surviving spouse. The trustee shall allocate the balance of the payment to principal. Upon  
7 request of the surviving spouse, the trustee shall allocate principal to income to the extent the  
8 internal income of the separate fund exceeds payments made from the separate fund to the trust  
9 during the accounting period.

10 (g) If a trustee cannot determine the internal income of a separate fund but can determine  
11 the value of the separate fund, the internal income of the separate fund is deemed to equal [insert  
12 number at least three percent and not more than five percent] of the fund’s value, according to  
13 the most recent statement of value preceding the beginning of the accounting period. If the  
14 trustee can determine neither the internal income of the separate fund nor the fund’s value, the  
15 internal income of the fund is deemed to equal the product of the interest rate and the present  
16 value of the expected future payments, as determined under Section 7520 of the Internal Revenue  
17 Code of 1986 [, as amended] [, 26 U.S.C. Section 7520] [, as amended], for the month preceding  
18 the accounting period for which the computation is made.

19 (h) This section does not apply to a payment to which Section 410 applies.

20 **Comment**

21 **Scope.** Section 409 applies to amounts received under contractual arrangements that  
22 provide for payments to a third party beneficiary as a result of services rendered or property  
23 transferred to the payer. While the right to receive such payments is a liquidating asset of the  
24 kind described in Section 410 (i.e., “an asset whose value will diminish or terminate because the  
25 asset is expected to produce receipts for a period of limited duration”), these payment rights are

1 covered separately in Section 409 because of their special characteristics.

2 Section 409 applies to receipts from all forms of annuities and deferred compensation  
3 arrangements, whether the payment will be received by the trust in a lump sum or in installments  
4 over a period of years. It applies to bonuses that may be received over two or three years and  
5 payments that may last for much longer periods, including payments from an individual  
6 retirement account (IRA), deferred compensation plan (whether qualified or not qualified for  
7 special federal income tax treatment), and insurance renewal commissions. It applies to a  
8 retirement plan to which the settlor has made contributions, just as it applies to an annuity policy  
9 that the settlor may have purchased individually, and it applies to variable annuities, deferred  
10 annuities, annuities issued by commercial insurance companies, and “private annuities” arising  
11 from the sale of property to another individual or entity in exchange for payments that are to be  
12 made for the life of one or more individuals. The section applies whether the payments begin  
13 when the payment right becomes subject to the trust or are deferred until a future date, and it  
14 applies whether payments are made in cash or in kind, such as employer stock (in-kind payments  
15 usually will be made in a single distribution that will be allocated to principal under the second  
16 sentence of subsection (c)).

17  
18 **The 1962 Act.** Under Section 12 of the 1962 Act, receipts from “rights to receive  
19 payments on a contract for deferred compensation” are allocated to income each year in an  
20 amount “not in excess of 5% per year” of the property’s inventory value. While “not in excess of  
21 5%” suggests that the annual allocation may range from zero to 5% of the inventory value, in  
22 practice the rule is usually treated as prescribing a 5% allocation. The inventory value is usually  
23 the present value of all the future payments, and since the inventory value is determined as of the  
24 date on which the payment right becomes subject to the trust, the inventory value, and thus the  
25 amount of the annual income allocation, depends significantly on the applicable interest rate on  
26 the decedent’s date of death. That rate may be much higher or lower than the average long-term  
27 interest rate. The amount determined under the 5% formula tends to become fixed and remain  
28 unchanged even though the amount received by the trust increases or decreases.

29  
30 **Allocations Under Section 409(b).** Section 409(b) applies to plans whose terms  
31 characterize payments made under the plan as dividends, interest, or payments in lieu of  
32 dividends or interest. For example, some deferred compensation plans that hold debt obligations  
33 or stock of the plan’s sponsor in an account for future delivery to the person rendering the  
34 services provide for the annual payment to that person of dividends received on the stock or  
35 interest received on the debt obligations. Other plans provide that the account of the person  
36 rendering the services shall be credited with “phantom” shares of stock and require an annual  
37 payment that is equivalent to the dividends that would be received on that number of shares if  
38 they were actually issued; or a plan may entitle the person rendering the services to receive a  
39 fixed dollar amount in the future and provide for the annual payment of interest on the deferred  
40 amount during the period prior to its payment. Under Section 409(b), payments of dividends,  
41 interest or payments in lieu of dividends or interest under plans of this type are allocated to  
42 income; all other payments received under these plans are allocated to principal.

43  
44 Section 409(b) does not apply to an IRA or an arrangement with payment provisions  
45 similar to an IRA. IRAs and similar arrangements are subject to the provisions in Section 409(c).

1           **Allocations Under Section 409(c).** The focus of Section 409, for purposes of allocating  
2 payments received by a trust to or between principal and income, is on the payment right rather  
3 than on assets that may be held in a fund from which the payments are made. Thus, if an IRA  
4 holds a portfolio of marketable stocks and bonds, the amount received by the IRA as dividends  
5 and interest is not taken into account in determining the principal and income allocation except to  
6 the extent that the Internal Revenue Service may require them to be taken into account when the  
7 payment is received by a trust that qualifies for the estate tax marital deduction (a situation that is  
8 provided for in Section 409(d)). An IRA is subject to federal income tax rules that require  
9 payments to begin by a particular date and be made over a specific number of years or a period  
10 measured by the lives of one or more persons. The payment right of a trust that is named as a  
11 beneficiary of an IRA is not a right to receive particular items that are paid to the IRA, but is  
12 instead the right to receive an amount determined by dividing the value of the IRA by the  
13 remaining number of years in the payment period. This payment right is similar to the right to  
14 receive a unitrust amount, which is normally expressed as an amount equal to a percentage of the  
15 value of the unitrust assets without regard to dividends or interest that may be received by the  
16 unitrust.

17  
18           An amount received from an IRA or a plan with a payment provision similar to that of an  
19 IRA is allocated under Section 409(c), which differentiates between payments that are required to  
20 be made and all other payments. To the extent that a payment is required to be made (either  
21 under federal income tax rules or, in the case of a plan that is not subject to those rules, under the  
22 terms of the plan), 10% of the amount received is allocated to income and the balance is  
23 allocated to principal. All other payments are allocated to principal because they represent a  
24 change in the form of a principal asset; Section 409 follows the rule in Section 404(2), which  
25 provides that money or property received from a change in the form of a principal asset be  
26 allocated to principal.

27  
28           Section 409(c) produces an allocation to income that is similar to the allocation under the  
29 1962 Act formula if the annual payments are the same throughout the payment period, and it is  
30 simpler to administer. The amount allocated to income under Section 409 is not dependent upon  
31 the interest rate that is used for valuation purposes when the decedent dies, and if the payments  
32 received by the trust increase or decrease from year to year because the fund from which the  
33 payment is made increases or decreases in value, the amount allocated to income will also  
34 increase or decrease.

35  
36           **Marital deduction requirements.** When an IRA or other retirement arrangement (a  
37 “plan”) is payable to a marital deduction trust, the IRS treats the plan as a separate property  
38 interest that itself must qualify for the marital deduction. IRS Revenue Ruling 2006-26 said that,  
39 as written, Section 409 does not cause a trust to qualify for the IRS’ safe harbors. Revenue  
40 Ruling 2006-26 was limited in scope to certain situations involving IRAs and defined  
41 contribution retirement plans. Without necessarily agreeing with the IRS’ position in that ruling,  
42 the revision to this section is designed to satisfy the IRS’ safe harbor and to address concerns that  
43 might be raised for similar assets. No IRS pronouncements have addressed the scope of  
44 Code § 2056(b)(7)(C).

1 Subsection (f) requires the trustee to demand certain distributions if the surviving spouse  
2 so requests. The safe harbor of Revenue Ruling 2006-26 requires that the surviving spouse be  
3 separately entitled to demand the fund's income (without regard to the income from the trust's  
4 other assets) and the income from the other assets (without regard to the fund's income). In any  
5 event, the surviving spouse is not required to demand that the trustee distribute all of the fund's  
6 income from the fund or from other trust assets. Treas. Reg. § 20.2056(b)-5(f)(8).

7  
8 Subsection (f) also recognizes that the trustee might not control the payments that the  
9 trustee receives and provides a remedy to the surviving spouse if the distributions under  
10 subsection (d)(1) are insufficient.

11  
12 Subsection (g) addresses situations where, due to lack of information provided by the  
13 fund's administrator, the trustee is unable to determine the fund's actual income. The bracketed  
14 language is the range approved for unitrust payments by Treas. Reg. § 1.643(b)-1. In  
15 determining the value for purposes of applying the unitrust percentage, the trustee would seek to  
16 obtain the value of the assets as of the most recent statement of value immediately preceding the  
17 beginning of the year. For example, suppose a trust's accounting period is January 1 through  
18 December 31. If a retirement plan administrator furnishes information annually each  
19 September 30 and declines to provide information as of December 31, then the trustee may rely  
20 on the September 30 value to determine the distribution for the following year. For funds whose  
21 values are not readily available, subsection (g) relies on Code section 7520 valuation methods  
22 because many funds described in Section 409 are annuities, and one consistent set of valuation  
23 principles should apply whether or not the fund is, in fact, an annuity.

24  
25 **Application of Section 104.** Section 104(a) of this Act gives a trustee who is acting  
26 under the prudent investor rule the power to adjust from principal to income if, considering the  
27 portfolio as a whole and not just receipts from deferred compensation, the trustee determines that  
28 an adjustment is necessary. See Example (5) in the Comment following Section 104.

## 29 30 **SECTION 410. LIQUIDATING ASSET.**

31 (a) In this section, "liquidating asset" means an asset whose value will diminish or  
32 terminate because the asset is expected to produce receipts for a period of limited duration. The  
33 term includes a leasehold, patent, copyright, royalty right, and right to receive payments during a  
34 period of more than one year under an arrangement that does not provide for the payment of  
35 interest on the unpaid balance. The term does not include a payment subject to Section 409,  
36 resources subject to Section 411, timber subject to Section 412, an activity subject to Section  
37 414, an asset subject to Section 415, or any asset for which the trustee establishes a reserve for



1 depreciation under Section 503.

2 (b) A trustee shall allocate to income 10 percent of the receipts from a liquidating asset  
3 and the balance to principal.

4 28. Arguably distributing (as income) a stated percentage of receipts is more  
5 practical than an annuity approach based on value. See Comment below. But is 10  
6 percent of receipts any less arbitrary than 5 percent of value? Where does 10 percent  
7 come from? (Section 411 presents essentially the same issue.) RDA

8 **Comment**

9 **Prior Acts.** Section 11 of the 1962 Act allocates receipts from “property subject to  
10 depletion” to income in an amount “not in excess of 5%” of the asset’s inventory value. The  
11 1931 Act has a similar 5% rule that applies when the trustee is under a duty to change the form of  
12 the investment. The 5% rule imposes on a trust the obligation to pay a fixed annuity to the  
13 income beneficiary until the asset is exhausted. Under both the 1931 and 1962 Acts the balance  
14 of each year’s receipts is added to principal. A fixed payment can produce unfair results. The  
15 remainder beneficiary receives all of the receipts from unexpected growth in the asset, e.g., if  
16 royalties on a patent or copyright increase significantly. Conversely, if the receipts diminish  
17 more rapidly than expected, most of the amount received by the trust will be allocated to income  
18 and little to principal. Moreover, if the annual payments remain the same for the life of the asset,  
19 the amount allocated to principal will usually be less than the original inventory value. For these  
20 reasons, Section 410 abandons the annuity approach under the 5% rule.

21  
22 **Lottery payments.** The reference in subsection (a) to rights to receive payments under  
23 an arrangement that does not provide for the payment of interest includes state lottery prizes and  
24 similar fixed amounts payable over time that are not deferred compensation arrangements  
25 covered by Section 409.

26  
27 **SECTION 411. MINERALS, WATER, AND OTHER NATURAL RESOURCES.**

28 (a) To the extent that a trustee accounts for receipts from an interest in minerals or other  
29 natural resources pursuant to this section, the trustee shall allocate them as follows:

30 (1) If received as nominal delay rental or nominal annual rent on a lease, a receipt  
31 must be allocated to income.

32 (2) If received from a production payment, a receipt must be allocated to income  
33 if and to the extent that the agreement creating the production payment provides a factor for

1 interest or its equivalent. The balance must be allocated to principal.

2 (3) If an amount received as a royalty, shut-in-well payment, take-or-pay  
3 payment, bonus, or delay rental is more than nominal, 90 percent must be allocated to principal  
4 and the balance to income.

5 (4) If an amount is received from a working interest or any other interest not  
6 provided for in paragraph (1), (2), or (3), 90 percent of the net amount received must be allocated  
7 to principal and the balance to income.

8 (b) An amount received on account of an interest in water that is renewable must be  
9 allocated to income. If the water is not renewable, 90 percent of the amount must be allocated to  
10 principal and the balance to income.

11 (c) This [Act] applies whether or not a decedent or donor was extracting minerals, water,  
12 or other natural resources before the interest became subject to the trust.

13 (d) If a trust owns an interest in minerals, water, or other natural resources on [the  
14 effective date of this [Act]], the trustee may allocate receipts from the interest as provided in this  
15 [Act] or in the manner used by the trustee before [the effective date of this [Act]]. If the trust  
16 acquires an interest in minerals, water, or other natural resources after [the effective date of this  
17 [Act]], the trustee shall allocate receipts from the interest as provided in this [Act].

18 **Comment**

19 **Prior Acts.** The 1962 Act allocates to principal as a depletion allowance, 27-1/2% of the  
20 gross receipts, but not more than 50% of the net receipts after paying expenses. The Internal  
21 Revenue Code no longer provides for a 27-1/2% depletion allowance, although the major  
22 oil-producing States have retained the 27-1/2% provision in their principal and income acts  
23 (Texas amended its Act in 1993, but did not change the depletion provision). Section 9 of the  
24 1931 Act allocates all of the net proceeds received as consideration for the “permanent severance  
25 of natural resources from the lands” to principal.

26  
27 Section 411 allocates 90% of the net receipts to principal and 10% to income. A

1 depletion provision that is tied to past or present Code provisions is undesirable because it causes  
2 a large portion of the oil and gas receipts to be paid out as income. As wells are depleted, the  
3 amount received by the income beneficiary falls drastically. Allocating a larger portion of the  
4 receipts to principal enables the trustee to acquire other income producing assets that will  
5 continue to produce income when the mineral reserves are exhausted.  
6

7 **Application of Sections 403 and 408.** This section applies to the extent that the trustee  
8 does not account separately for receipts from minerals and other natural resources under Section  
9 403 or allocate all of the receipts to principal under Section 408.  
10

11 **Open mine doctrine.** The purpose of Section 411(c) is to abolish the “open mine  
12 doctrine” as it may apply to the rights of an income beneficiary and a remainder beneficiary in  
13 receipts from the production of minerals from land owned or leased by a trust. Instead, such  
14 receipts are to be allocated to or between principal and income in accordance with the provisions  
15 of this Act. For a discussion of the open mine doctrine, see generally 3A Austin W. Scott &  
16 William F. Fratcher, *The Law of Trusts* § 239.3 (4th ed. 1988), and *Nutter v. Stockton*, 626 P.2d  
17 861 (Okla. 1981).  
18

19 **Effective date provision.** Section 9(b) of the 1962 Act provides that the natural  
20 resources provision does not apply to property interests held by the trust on the effective date of  
21 the Act, which reflects concerns about the constitutionality of applying a retroactive  
22 administrative provision to interests in real estate, based on the opinion in the Oklahoma case of  
23 *Franklin v. Margay Oil Corporation*, 153 P.2d 486, 501 (Okla. 1944). Section 411(d) permits a  
24 trustee to use either the method provided for in this Act or the method used before the Act takes  
25 effect. Lawyers in jurisdictions other than Oklahoma may conclude that retroactivity is not a  
26 problem as to property situated in their States, and this provision permits trustees to decide, based  
27 on advice from counsel in States whose law may be different from that of Oklahoma, whether  
28 they may apply this provision retroactively if they conclude that to do so is in the best interests of  
29 the beneficiaries.  
30

31 If the property is in a State other than the State where the trust is administered, the trustee  
32 must be aware that the law of the property’s situs may control this question. The outcome turns  
33 on a variety of questions: whether the terms of the trust specify that the law of a State other than  
34 the situs of the property shall govern the administration of the trust, and whether the courts will  
35 follow the terms of the trust; whether the trust’s asset is the land itself or a leasehold interest in  
36 the land (as it frequently is with oil and gas property); whether a leasehold interest or its proceeds  
37 should be classified as real property or personal property, and if as personal property, whether  
38 applicable state law treats it as a movable or an immovable for conflict of laws purposes. See 5A  
39 Austin W. Scott & William F. Fratcher, *The Law of Trusts* “ 648, at 531, 533-534; § 657, at 600  
40 (4th ed. 1989).  
41

## 42 **SECTION 412. TIMBER.**

43 (a) To the extent that a trustee accounts for receipts from the sale of timber and related

1 products pursuant to this section, the trustee shall allocate the net receipts:

2 (1) to income to the extent that the amount of timber removed from the land does  
3 not exceed the rate of growth of the timber during the accounting periods in which a beneficiary  
4 has a mandatory income interest;

5 (2) to principal to the extent that the amount of timber removed from the land  
6 exceeds the rate of growth of the timber or the net receipts are from the sale of standing timber;

7 (3) to or between income and principal if the net receipts are from the lease of  
8 timberland or from a contract to cut timber from land owned by a trust, by determining the  
9 amount of timber removed from the land under the lease or contract and applying the rules in  
10 paragraphs (1) and (2); or

11 (4) to principal to the extent that advance payments, bonuses, and other payments  
12 are not allocated pursuant to paragraph (1), (2), or (3).

13 (b) In determining net receipts to be allocated pursuant to subsection (a), a trustee shall  
14 deduct and transfer to principal a reasonable amount for depletion.

15 (c) This [Act] applies whether or not a decedent or transferor was harvesting timber from  
16 the property before it became subject to the trust.

17 (d) If a trust owns an interest in timberland on [the effective date of this [Act]], the  
18 trustee may allocate net receipts from the sale of timber and related products as provided in this  
19 [Act] or in the manner used by the trustee before [the effective date of this [Act]]. If the trust  
20 acquires an interest in timberland after [the effective date of this [Act]], the trustee shall allocate  
21 net receipts from the sale of timber and related products as provided in this [Act].

22 **Comment**

23 **Scope of section.** The rules in Section 412 are intended to apply to net receipts from the

1 sale of trees and by-products from harvesting and processing trees without regard to the kind of  
2 trees that are cut or whether the trees are cut before or after a particular number of years of  
3 growth. The rules apply to the sale of trees that are expected to produce lumber for building  
4 purposes, trees sold as pulpwood, and Christmas and other ornamental trees. Subsection (a)  
5 applies to net receipts from property owned by the trustee and property leased by the trustee. The  
6 Act is not intended to prevent a tenant in possession of the property from using wood that he cuts  
7 on the property for personal, noncommercial purposes, such as a Christmas tree, firewood,  
8 mending old fences or building new fences, or making repairs to structures on the property.  
9

10 Under subsection (a), the amount of net receipts allocated to income depends upon  
11 whether the amount of timber removed is more or less than the rate of growth. The method of  
12 determining the amount of timber removed and the rate of growth is up to the trustee, based on  
13 methods customarily used for the kind of timber involved.  
14

15 **Application of Sections 403 and 408.** This section applies to the extent that the trustee  
16 does not account separately for net receipts from the sale of timber and related products under  
17 Section 403 or allocate all of the receipts to principal under Section 408. The option to account  
18 for net receipts separately under Section 403 takes into consideration the possibility that timber  
19 harvesting operations may have been conducted before the timber property became subject to the  
20 trust, and that it may make sense to continue using accounting methods previously established for  
21 the property. It also permits a trustee to use customary accounting practices for timber operations  
22 even if no harvesting occurred on the property before it became subject to the trust.  
23

#### 24 **SECTION 413. PROPERTY NOT PRODUCTIVE OF INCOME.**

25 (a) If a marital deduction is allowed for all or part of a trust whose assets consist  
26 substantially of property that does not provide the spouse with sufficient income from or use of  
27 the trust assets, and if the amounts that the trustee transfers from principal to income under  
28 Section 104 and distributes to the spouse from principal pursuant to the terms of the trust are  
29 insufficient to provide the spouse with the beneficial enjoyment required to obtain the marital  
30 deduction, the spouse may require the trustee to make property productive of income, convert  
31 property within a reasonable time, or exercise the power conferred by Section 104(a). The  
32 trustee may decide which action or combination of actions to take.

33 (b) In cases not governed by subsection (a), proceeds from the sale or other disposition of  
34 an asset are principal without regard to the amount of income the asset produces during any

1 accounting period.

2 **Comment**

3 **Prior Acts' Conflict with Uniform Prudent Investor Act.** Section 2(b) of the Uniform  
4 Prudent Investor Act provides that “[a] trustee’s investment and management decisions  
5 respecting individual assets must be evaluated not in isolation but in the context of the trust  
6 portfolio as a whole ... .” The underproductive property provisions in Section 12 of the 1962 Act  
7 and Section 11 of the 1931 Act give the income beneficiary a right to receive a portion of the  
8 proceeds from the sale of underproductive property as “delayed income.” In each Act the  
9 provision applies on an asset by asset basis and not by taking into consideration the trust  
10 portfolio as a whole, which conflicts with the basic precept in Section 2(b) of the Prudent  
11 Investor Act. Moreover, in determining the amount of delayed income, the prior Acts do not  
12 permit a trustee to take into account the extent to which the trustee may have distributed principal  
13 to the income beneficiary, under principal invasion provisions in the terms of the trust, to  
14 compensate for insufficient income from the unproductive asset. Under Section 104(b)(7) of this  
15 Act, a trustee must consider prior distributions of principal to the income beneficiary in deciding  
16 whether and to what extent to exercise the power to adjust conferred by Section 104(a).

17  
18 **Duty to make property productive of income.** In order to implement the Uniform  
19 Prudent Investor Act, this Act abolishes the right to receive delayed income from the sale  
20 proceeds of an asset that produces little or no income, but it does not alter existing state law  
21 regarding the income beneficiary’s right to compel the trustee to make property productive of  
22 income. As the law continues to develop in this area, the duty to make property productive of  
23 current income in a particular situation should be determined by taking into consideration the  
24 performance of the portfolio as a whole and the extent to which a trustee makes principal  
25 distributions to the income beneficiary under the terms of the trust and adjustments between  
26 principal and income under Section 104 of this Act.

27  
28 Trusts for which the value of the right to receive income is important for tax reasons may  
29 be affected by Reg. § 1.7520-3(b)(2)(v) *Example (1)*, § 20.7520-3(b)(2)(v) *Examples (1) and (2)*,  
30 and § 25.7520-3(b)(2)(v) *Examples (1) and (2)*, which provide that if the income beneficiary does  
31 not have the right to compel the trustee to make the property productive, the income interest is  
32 considered unproductive and may not be valued actuarially under those sections.

33  
34 **Marital deduction trusts.** Subsection (a) draws on language in Reg. § 20.2056(b)-  
35 5(f)(4) and (5) to enable a trust for a spouse to qualify for a marital deduction if applicable state  
36 law is unclear about the spouse’s right to compel the trustee to make property productive of  
37 income. The trustee should also consider the application of Section 104 of this Act and the  
38 provisions of Restatement of Trusts 3d: Prudent Investor Rule § 240, at 186, app. § 240, at 252  
39 (1992). Example (6) in the Comment to Section 104 describes a situation involving the payment  
40 from income of carrying charges on unproductive real estate in which Section 104 may apply.

41  
42 Once the two conditions have occurred - insufficient beneficial enjoyment from the  
43 property and the spouse’s demand that the trustee take action under this section - the trustee must

1 act; but instead of the formulaic approach of the 1962 Act, which is triggered only if the trustee  
2 sells the property, this Act permits the trustee to decide whether to make the property productive  
3 of income, convert it, transfer funds from principal to income, or to take some combination of  
4 those actions. The trustee may rely on the power conferred by Section 104(a) to adjust from  
5 principal to income if the trustee decides that it is not feasible or appropriate to make the property  
6 productive of income or to convert the property. Given the purpose of Section 413, the power  
7 under Section 104(a) would be exercised to transfer principal to income and not to transfer  
8 income to principal.

9  
10 Section 413 does not apply to a so-called “estate” trust, which will qualify for the marital  
11 deduction, even though the income may be accumulated for a term of years or for the life of the  
12 surviving spouse, if the terms of the trust require the principal and undistributed income to be  
13 paid to the surviving spouse’s estate when the spouse dies. Reg. § 20.2056(c)-2(b)(1)(iii).

#### 14 **SECTION 414. DERIVATIVES AND OPTIONS.**

15  
16 (a) In this section, “derivative” means a contract or financial instrument or a combination  
17 of contracts and financial instruments which gives a trust the right or obligation to participate in  
18 some or all changes in the price of a tangible or intangible asset or group of assets, or changes in  
19 a rate, an index of prices or rates, or other market indicator for an asset or a group of assets.

20 (b) To the extent that a trustee does not account under Section 403 for transactions in  
21 derivatives, the trustee shall allocate to principal receipts from and disbursements made in  
22 connection with those transactions.

23 (c) If a trustee grants an option to buy property from the trust, whether or not the trust  
24 owns the property when the option is granted, grants an option that permits another person to sell  
25 property to the trust, or acquires an option to buy property for the trust or an option to sell an  
26 asset owned by the trust, and the trustee or other owner of the asset is required to deliver the asset  
27 if the option is exercised, an amount received for granting the option must be allocated to  
28 principal. An amount paid to acquire the option must be paid from principal. A gain or loss  
29 realized upon the exercise of an option, including an option granted to a settlor of the trust for  
30 services rendered, must be allocated to principal.

1 **Comment**

2 **Scope and application.** It is difficult to predict how frequently and to what extent  
3 trustees will invest directly in derivative financial instruments rather than participating indirectly  
4 through investment entities that may utilize these instruments in varying degrees. If the trust  
5 participates in derivatives indirectly through an entity, an amount received from the entity will be  
6 allocated under Section 401 and not Section 414. If a trustee invests directly in derivatives to a  
7 significant extent, the expectation is that receipts and disbursements related to derivatives will be  
8 accounted for under Section 403; if a trustee chooses not to account under Section 403, Section  
9 414(b) provides the default rule. Certain types of option transactions in which trustees may  
10 engage are dealt with in subsection (c) to distinguish those transactions from ones involving  
11 options that are embedded in derivative financial instruments.  
12

13 **Definition of “derivative.”** “Derivative” is a difficult term to define because new  
14 derivatives are invented daily as dealers tailor their terms to achieve specific financial objectives  
15 for particular clients. Since derivatives are typically contract-based, a derivative can probably be  
16 devised for almost any set of objectives if another party can be found who is willing to assume  
17 the obligations required to meet those objectives.  
18

19 The most comprehensive definition of derivative is in the Exposure Draft of a Proposed  
20 Statement of Financial Accounting Standards titled “Accounting for Derivative and Similar  
21 Financial Instruments and for Hedging Activities,” which was released by the Financial  
22 Accounting Standards Board (FASB) on June 20, 1996 (No. 162-B). The definition in Section  
23 414(a) is derived in part from the FASB definition. The purpose of the definition in subsection  
24 (a) is to implement the substantive rule in subsection (b) that provides for all receipts and  
25 disbursements to be allocated to principal to the extent the trustee elects not to account for  
26 transactions in derivatives under Section 403. As a result, it is much shorter than the FASB  
27 definition, which serves much more ambitious objectives.  
28

29 A derivative is frequently described as including futures, forwards, swaps and options,  
30 terms that also require definition, and the definition in this Act avoids these terms. FASB used  
31 the same approach, explaining in paragraph 65 of the Exposure Draft:  
32

33 The definition of *derivative financial instrument* in this Statement includes those financial  
34 instruments generally considered to be derivatives, such as forwards, futures, swaps, options, and  
35 similar instruments. The Board considered defining a derivative financial instrument by merely  
36 referencing those commonly understood instruments, similar to paragraph 5 of Statement 119,  
37 which says that “... a derivative financial instrument is a futures, forward, swap, or option  
38 contract, or other financial instrument with similar characteristics.” However, the continued  
39 development of financial markets and innovative financial instruments could ultimately render a  
40 definition based on examples inadequate and obsolete. The Board, therefore, decided to base the  
41 definition of a derivative financial instrument on a description of the common characteristics of  
42 those instruments in order to accommodate the accounting for newly developed derivatives.  
43 (Footnote omitted.)  
44



1           **Marking to market.** A gain or loss that occurs because the trustee marks securities to  
2 market or to another value during an accounting period is not a transaction in a derivative  
3 financial instrument that is income or principal under the Act - only cash receipts and  
4 disbursements, and the receipt of property in exchange for a principal asset, affect a trust's  
5 principal and income accounts.  
6

7           **Receipt of property other than cash.** If a trustee receives property other than cash upon  
8 the settlement of a derivatives transaction, that property would be principal under Section 404(2).  
9

10           **Options.** Options to which subsection (c) applies include an option to purchase real  
11 estate owned by the trustee and a put option purchased by a trustee to guard against a drop in  
12 value of a large block of marketable stock that must be liquidated to pay estate taxes. Subsection  
13 (c) would also apply to a continuing and regular practice of selling call options on securities  
14 owned by the trust if the terms of the option require delivery of the securities. It does not apply if  
15 the consideration received or given for the option is something other than cash or property, such  
16 as cross-options granted in a buy-sell agreement between owners of an entity.  
17

#### 18           **SECTION 415. ASSET-BACKED SECURITIES.**

19           (a) In this section, "asset-backed security" means an asset whose value is based upon the  
20 right it gives the owner to receive distributions from the proceeds of financial assets that provide  
21 collateral for the security. The term includes an asset that gives the owner the right to receive  
22 from the collateral financial assets only the interest or other current return or only the proceeds  
23 other than interest or current return. The term does not include an asset to which Section 401 or  
24 409 applies.

25           (b) If a trust receives a payment from interest or other current return and from other  
26 proceeds of the collateral financial assets, the trustee shall allocate to income the portion of the  
27 payment which the payer identifies as being from interest or other current return and shall  
28 allocate the balance of the payment to principal.

29           (c) If a trust receives one or more payments in exchange for the trust's entire interest in  
30 an asset-backed security in one accounting period, the trustee shall allocate the payments to  
31 principal. If a payment is one of a series of payments that will result in the liquidation of the

1 trust’s interest in the security over more than one accounting period, the trustee shall allocate 10  
2 percent of the payment to income and the balance to principal.

3 **Comment**

4 **Scope of section.** Typical asset-backed securities include arrangements in which debt  
5 obligations such as real estate mortgages, credit card receivables and auto loans are acquired by  
6 an investment trust and interests in the trust are sold to investors. The source for payments to an  
7 investor is the money received from principal and interest payments on the underlying debt. An  
8 asset-backed security includes an “interest only” or a “principal only” security that permits the  
9 investor to receive only the interest payments received from the bonds, mortgages or other assets  
10 that are the collateral for the asset-backed security, or only the principal payments made on those  
11 collateral assets. An asset-backed security also includes a security that permits the investor to  
12 participate in either the capital appreciation of an underlying security or in the interest or  
13 dividend return from such a security, such as the “Primes” and “Scores” issued by Americus  
14 Trust. An asset-backed security does not include an interest in a corporation, partnership, or an  
15 investment trust described in the Comment to Section 402, whose assets consist significantly or  
16 entirely of investment assets. Receipts from an instrument that do not come within the scope of  
17 this section or any other section of the Act would be allocated entirely to principal under the rule  
18 in Section 103(a)(4), and the trustee may then consider whether and to what extent to exercise the  
19 power to adjust in Section 104, taking into account the return from the portfolio as whole and  
20 other relevant factors.

21  
22 **[ARTICLE] 5**

23 **ALLOCATION OF DISBURSEMENTS DURING ADMINISTRATION OF TRUST**

24 **SECTION 501. DISBURSEMENTS FROM INCOME.** A trustee shall make the  
25 following disbursements from income to the extent that they are not disbursements to which  
26 Section 201(2)(B) or (C) applies

27 (1) one-half of the regular compensation of the trustee and of any person providing  
28 investment advisory or custodial services to the trustee;

29 (2) one-half of all expenses for accountings, judicial proceedings, or other matters that  
30 involve both the income and remainder interests;

31 

29. Should other professional fees, including attorneys’ fees, be explicitly 32 addressed? Only for “matters that involve both the income and remainder interests”? 33 Is that test workable? RDA
---

1 (3) all of the other ordinary expenses incurred in connection with the administration,  
2 management, or preservation of trust property and the distribution of income, including interest,  
3 ordinary repairs, regularly recurring taxes assessed against principal, and expenses of a  
4 proceeding or other matter that concerns primarily the income interest; and

5 (4) recurring premiums on insurance covering the loss of a principal asset or the loss of  
6 income from or use of the asset.

7 **Comment**

8 **Trustee fees.** The regular compensation of a trustee or the trustee’s agent includes  
9 compensation based on a percentage of either principal or income or both.

10  
11 **Insurance premiums.** The reference in paragraph (4) to “recurring” premiums is  
12 intended to distinguish premiums paid annually for fire insurance from premiums on title  
13 insurance, each of which covers the loss of a principal asset. Title insurance premiums would be  
14 a principal disbursement under Section 502(a)(5).

15  
16 **Regularly recurring taxes.** The reference to “regularly recurring taxes assessed against  
17 principal” includes all taxes regularly imposed on real property and tangible and intangible  
18 personal property.

19  
20 **SECTION 502. DISBURSEMENTS FROM PRINCIPAL.**

21 (a) A trustee shall make the following disbursements from principal:

22 (1) the remaining one-half of the disbursements described in Section 501(1) and  
23 (2);

24 (2) all of the trustee’s compensation calculated on principal as a fee for  
25 acceptance, distribution, or termination, and disbursements made to prepare property for sale;

26 (3) payments on the principal of a trust debt;

27 (4) expenses of a proceeding that concerns primarily principal, including a  
28 proceeding to construe the trust or to protect the trust or its property;

29 (5) premiums paid on a policy of insurance not described in Section 501(4) of

1 which the trust is the owner and beneficiary;

2 (6) estate, inheritance, and other transfer taxes, including penalties, apportioned to  
3 the trust; and

4 (7) disbursements related to environmental matters, including reclamation,  
5 assessing environmental conditions, remedying and removing environmental contamination,  
6 monitoring remedial activities and the release of substances, preventing future releases of  
7 substances, collecting amounts from persons liable or potentially liable for the costs of those  
8 activities, penalties imposed under environmental laws or regulations and other payments made  
9 to comply with those laws or regulations, statutory or common law claims by third parties, and  
10 defending claims based on environmental matters.

11 (b) If a principal asset is encumbered with an obligation that requires income from that  
12 asset to be paid directly to the creditor, the trustee shall transfer from principal to income an  
13 amount equal to the income paid to the creditor in reduction of the principal balance of the  
14 obligation.

15 **Comment**

16 **Environmental expenses.** All environmental expenses are payable from principal,  
17 subject to the power of the trustee to transfer funds to principal from income under Section 504.  
18 However, the Drafting Committee decided that it was not necessary to broaden this provision to  
19 cover other expenditures made under compulsion of governmental authority. See generally the  
20 annotation at 43 A.L.R.4th 1012 (Duty as Between Life Tenant and Remainderman with Respect  
21 to Cost of Improvements or Repairs Made Under Compulsion of Governmental Authority).  
22

23 Environmental expenses paid by a trust are to be paid from principal under Section  
24 502(a)(7) on the assumption that they will usually be extraordinary in nature. Environmental  
25 expenses might be paid from income if the trustee is carrying on a business that uses or sells  
26 toxic substances, in which case environmental cleanup costs would be a normal cost of doing  
27 business and would be accounted for under Section 403. In accounting under that Section,  
28 environmental costs will be a factor in determining how much of the net receipts from the  
29 business is trust income. Paying all other environmental expenses from principal is consistent  
30 with this Act's approach regarding receipts - when a receipt is not clearly a current return on a

1 principal asset, it should be added to principal because over time both the income and remainder  
2 beneficiaries benefit from this treatment. Here, allocating payments required by environmental  
3 laws to principal imposes the detriment of those payments over time on both the income and  
4 remainder beneficiaries.

5 Under Sections 504(a) and 504(b)(5), a trustee who makes or expects to make a principal  
6 disbursement for an environmental expense described in Section 502(a)(7) is authorized to  
7 transfer an appropriate amount from income to principal to reimburse principal for disbursements  
8 made or to provide a reserve for future principal disbursements.

9  
10 The first part of Section 502(a)(7) is based upon the definition of an “environmental  
11 remediation trust” in Treas. Reg. § 301.7701-4(e)(as amended in 1996). This is not because the  
12 Act applies to an environmental remediation trust, but because the definition is a useful and  
13 thoroughly vetted description of the kinds of expenses that a trustee owning contaminated  
14 property might incur. Expenses incurred to comply with environmental laws include the cost of  
15 environmental consultants, administrative proceedings and burdens of every kind imposed as the  
16 result of an administrative or judicial proceeding, even though the burden is not formally  
17 characterized as a penalty.

18  
19 **Title proceedings.** Disbursements that are made to protect a trust’s property, referred to  
20 in Section 502(a)(4), include an “action to assure title” that is mentioned in Section 13(c)(2) of  
21 the 1962 Act.

22  
23 **Insurance premiums.** Insurance premiums referred to in Section 502(a)(5) include title  
24 insurance premiums. They also include premiums on life insurance policies owned by the trust,  
25 which represent the trust’s periodic investment in the insurance policy. There is no provision in  
26 the 1962 Act for life insurance premiums.

27  
28 **Taxes.** Generation-skipping transfer taxes are payable from principal under subsection  
29 (a)(6).

### 30 **SECTION 503. TRANSFERS FROM INCOME TO PRINCIPAL FOR**

#### 31 **DEPRECIATION.**

32  
33 (a) In this section, “depreciation” means a reduction in value due to wear, tear, decay,  
34 corrosion, or gradual obsolescence of a fixed asset having a useful life of more than one year.

35 (b) A trustee may transfer to principal a reasonable amount of the net cash receipts from a  
36 principal asset that is subject to depreciation, but may not transfer any amount for depreciation:

37 (1) of that portion of real property used or available for use by a beneficiary as a  
38 residence or of tangible personal property held or made available for the personal use or

1 enjoyment of a beneficiary;  
2 (2) during the administration of a decedent's estate; or  
3 (3) under this section if the trustee is accounting under Section 403 for the  
4 business or activity in which the asset is used.

5 (c) An amount transferred to principal need not be held as a separate fund.

6 **Comment**

7 **Prior Acts.** The 1931 Act has no provision for depreciation. Section 13(a)(2) of the 1962  
8 Act provides that a charge shall be made against income for "... a reasonable allowance for  
9 depreciation on property subject to depreciation under generally accepted accounting principles  
10 ... ." That provision has been resisted by many trustees, who do not provide for any depreciation  
11 for a variety of reasons. One reason relied upon is that a charge for depreciation is not needed to  
12 protect the remainder beneficiaries if the value of the land is increasing; another is that generally  
13 accepted accounting principles may not require depreciation to be taken if the property is not part  
14 of a business. The Drafting Committee concluded that the decision to provide for depreciation  
15 should be discretionary with the trustee. The power to transfer funds from income to principal  
16 that is granted by this section is a discretionary power of administration referred to in Section  
17 103(b), and in exercising the power a trustee must comply with Section 103(b).

18  
19 One purpose served by transferring cash from income to principal for depreciation is to  
20 provide funds to pay the principal of an indebtedness secured by the depreciable property.  
21 Section 504(b)(4) permits the trustee to transfer additional cash from income to principal for this  
22 purpose to the extent that the amount transferred from income to principal for depreciation is less  
23 than the amount of the principal payments.

24  
25 **SECTION 504. TRANSFERS FROM INCOME TO REIMBURSE PRINCIPAL.**

26 (a) If a trustee makes or expects to make a principal disbursement described in this  
27 section, the trustee may transfer an appropriate amount from income to principal in one or more  
28 accounting periods to reimburse principal or to provide a reserve for future principal  
29 disbursements.

30 (b) Principal disbursements to which subsection (a) applies include the following, but  
31 only to the extent that the trustee has not been and does not expect to be reimbursed by a third  
32 party:

1 (1) an amount chargeable to income but paid from principal because it is  
2 unusually large, including extraordinary repairs;

3 (2) a capital improvement to a principal asset, whether in the form of changes to  
4 an existing asset or the construction of a new asset, including special assessments;

5 (3) disbursements made to prepare property for rental, including tenant  
6 allowances, leasehold improvements, and broker's commissions;

7 (4) periodic payments on an obligation secured by a principal asset to the extent  
8 that the amount transferred from income to principal for depreciation is less than the periodic  
9 payments; and

10 (5) disbursements described in Section 502(a)(7).

11 (c) If the asset whose ownership gives rise to the disbursements becomes subject to a  
12 successive income interest after an income interest ends, a trustee may continue to transfer  
13 amounts from income to principal as provided in subsection (a).

14 **Comment**

15 **Prior Acts.** The sources of Section 504 are Section 13(b) of the 1962 Act, which permits  
16 a trustee to "regularize distributions," if charges against income are unusually large, by using  
17 "reserves or other reasonable means" to withhold sums from income distributions; Section  
18 13(c)(3) of the 1962 Act, which authorizes a trustee to establish an allowance for depreciation out  
19 of income if principal is used for extraordinary repairs, capital improvements and special  
20 assessments; and Section 12(3) of the 1931 Act, which permits the trustee to spread income  
21 expenses of unusual amount "throughout a series of years." Section 504 contains a more detailed  
22 enumeration of the circumstances in which this authority may be used, and includes in subsection  
23 (b)(4) the express authority to use income to make principal payments on a mortgage if the  
24 depreciation charge against income is less than the principal payments on the mortgage.

25  
26 **SECTION 505. INCOME TAXES.**

27 

30. This was also revised in 2008. RDA
--

28 (a) A tax required to be paid by a trustee based on receipts allocated to income must be

1 paid from income.

2 (b) A tax required to be paid by a trustee based on receipts allocated to principal must be  
3 paid from principal, even if the tax is called an income tax by the taxing authority.

4 (c) A tax required to be paid by a trustee on the trust's share of an entity's taxable  
5 income must be paid:

6 (1) from income to the extent that receipts from the entity are allocated only to  
7 income;

8 (2) from principal to the extent that receipts from the entity are allocated only to  
9 principal;

10 (3) proportionately from principal and income to the extent that receipts from the  
11 entity are allocated to both income and principal; and

12 (4) from principal to the extent that the tax exceeds the total receipts from the  
13 entity.

14 (d) After applying subsections (a) through (c), the trustee shall adjust income or principal  
15 receipts to the extent that the trust's taxes are reduced because the trust receives a deduction for  
16 payments made to a beneficiary.

### 17 **Comment**

18  
19 **Taxes on Undistributed Entity Taxable Income.** When a trust owns an interest in a  
20 pass-through entity, such as a partnership or S corporation, it must report its share of the entity's  
21 taxable income regardless of how much the entity distributes to the trust. Whether the entity  
22 distributes more or less than the trust's tax on its share of the entity's taxable income, the trust  
23 must pay the taxes and allocate them between income and principal.  
24

25 Subsection (c) requires the trust to pay the taxes on its share of an entity's taxable income  
26 from income or principal receipts to the extent that receipts from the entity are allocable to each.  
27 This assures the trust a source of cash to pay some or all of the taxes on its share of the entity's  
28 taxable income. Subsection 505(d) recognizes that, except in the case of an Electing Small  
29 Business Trust (ESBT), a trust normally receives a deduction for amounts distributed to a



1 beneficiary. Accordingly, subsection 505(d) requires the trust to increase receipts payable to a  
2 beneficiary as determined under subsection (c) to the extent the trust's taxes are reduced by  
3 distributing those receipts to the beneficiary.  
4

5 Because the trust's taxes and amounts distributed to a beneficiary are interrelated, the  
6 trust may be required to apply a formula to determine the correct amount payable to a  
7 beneficiary. This formula should take into account that each time a distribution is made to a  
8 beneficiary, the trust taxes are reduced and amounts distributable to a beneficiary are increased.  
9 The formula assures that after deducting distributions to a beneficiary, the trust has enough to  
10 satisfy its taxes on its share of the entity's taxable income as reduced by distributions to  
11 beneficiaries.  
12

13 **Example (1)** – Trust T receives a Schedule K-1 from Partnership P reflecting taxable  
14 income of \$1 million. Partnership P distributes \$100,000 to T, which allocates the receipts to  
15 income. Both Trust T and income Beneficiary B are in the 35 percent tax bracket.  
16 Trust T's tax on \$1 million of taxable income is \$350,000. Under Subsection (c) T's tax must be  
17 paid from income receipts because receipts from the entity are allocated only to income.  
18 Therefore, T must apply the entire \$100,000 of income receipts to pay its tax. In this case,  
19 Beneficiary B receives nothing.  
20

21 **Example (2)** - Trust T receives a Schedule K-1 from Partnership P reflecting taxable  
22 income of \$1 million. Partnership P distributes \$500,000 to T, which allocates the receipts to  
23 income. Both Trust T and income Beneficiary B are in the 35 percent tax bracket.  
24 Trust T's tax on \$1 million of taxable income is \$350,000. Under Subsection (c), T's tax must be  
25 paid from income receipts because receipts from P are allocated only to income. Therefore, T  
26 uses \$350,000 of the \$500,000 to pay its taxes and distributes the remaining \$150,000 to B. The  
27 \$150,000 payment to B reduces T's taxes by \$52,500, which it must pay to B. But the \$52,500  
28 further reduces T's taxes by \$18,375, which it also must pay to B. In fact, each time T makes a  
29 distribution to B, its taxes are further reduced, causing another payment to be due B.  
30

31 Alternatively, T can apply the following algebraic formula to determine the amount  
32 payable to B:  
33

$$34 \quad D = (C - R \times K) / (1 - R)$$

35  $D$  = Distribution to income beneficiary

36  $C$  = Cash paid by the entity to the trust

37  $R$  = tax rate on income

38  $K$  = entity's K-1 taxable income  
39  
40

41 Applying the formula to Example (2) above, Trust T must pay \$230,769 to B so that after  
42 deducting the payment, T has exactly enough to pay its tax on the remaining taxable income from  
43 P.

1	Taxable Income per K-1	1,000,000
2	Payment to beneficiary	230,769 <sup>1</sup>
3	Trust Taxable Income \$	769,231
4	35 percent tax	269,231
5		
6	Partnership Distribution	\$ 500,000
7	Fiduciary's Tax Liability	(269,231)
8	Payable to the Beneficiary	\$ 230,769
9		

10 In addition, B will report \$230,769 on his or her own personal income tax return, paying  
11 taxes of \$80,769. Because Trust T withheld \$269,231 to pay its taxes and B paid \$80,769 taxes  
12 of its own, B bore the entire \$350,000 tax burden on the \$1 million of entity taxable income,  
13 including the \$500,000 that the entity retained that presumably increased the value of the trust's  
14 investment entity.

15  
16 If a trustee determines that it is appropriate to so, it should consider exercising the  
17 discretion granted in UPIA section 506 to adjust between income and principal. Alternatively, the  
18 trustee may exercise the power to adjust under UPIA section 104 to the extent it is available and  
19 appropriate under the circumstances, including whether a future distribution from the entity that  
20 would be allocated to principal should be reallocated to income because the income beneficiary  
21 already bore the burden of taxes on the reinvested income. In exercising the power, the trust  
22 should consider the impact that future distributions will have on any current adjustments.

23  
24 **SECTION 506. ADJUSTMENTS BETWEEN PRINCIPAL AND INCOME**  
25 **BECAUSE OF TAXES.**

26 (a) A fiduciary may make adjustments between principal and income to offset the shifting  
27 of economic interests or tax benefits between income beneficiaries and remainder beneficiaries  
28 which arise from:

29 (1) elections and decisions, other than those described in subsection (b), that the  
30 fiduciary makes from time to time regarding tax matters;

31 (2) an income tax or any other tax that is imposed upon the fiduciary or a  
32 beneficiary as a result of a transaction involving or a distribution from the estate or trust; or

---

<sup>1</sup>  $D = (C - R \times K) / (1 - R) = (500,000 - 350,000) / (1 - .35) = \$230,769$ . (D is the amount payable to the income beneficiary, K is the entity's K-1 taxable income, R is the trust ordinary tax rate, and C is the cash distributed by the entity).

1 (3) the ownership by an estate or trust of an interest in an entity whose taxable  
2 income, whether or not distributed, is includable in the taxable income of the estate, trust, or a  
3 beneficiary.

4 (b) If the amount of an estate tax marital deduction or charitable contribution deduction  
5 is reduced because a fiduciary deducts an amount paid from principal for income tax purposes  
6 instead of deducting it for estate tax purposes, and as a result estate taxes paid from principal are  
7 increased and income taxes paid by an estate, trust, or beneficiary are decreased, each estate,  
8 trust, or beneficiary that benefits from the decrease in income tax shall reimburse the principal  
9 from which the increase in estate tax is paid. The total reimbursement must equal the increase in  
10 the estate tax to the extent that the principal used to pay the increase would have qualified for a  
11 marital deduction or charitable contribution deduction but for the payment. The proportionate  
12 share of the reimbursement for each estate, trust, or beneficiary whose income taxes are reduced  
13 must be the same as its proportionate share of the total decrease in income tax. An estate or trust  
14 shall reimburse principal from income.

#### 15 **Comment**

16 **Discretionary adjustments.** Section 506(a) permits the fiduciary to make adjustments  
17 between income and principal because of tax law provisions. It would permit discretionary  
18 adjustments in situations like these: (1) A fiduciary elects to deduct administration expenses that  
19 are paid from principal on an income tax return instead of on the estate tax return; (2) a  
20 distribution of a principal asset to a trust or other beneficiary causes the taxable income of an  
21 estate or trust to be carried out to the distributee and relieves the persons who receive the income  
22 of any obligation to pay income tax on the income; or (3) a trustee realizes a capital gain on the  
23 sale of a principal asset and pays a large state income tax on the gain, but under applicable  
24 federal income tax rules the trustee may not deduct the state income tax payment from the capital  
25 gain in calculating the trust's federal capital gain tax, and the income beneficiary receives the  
26 benefit of the deduction for state income tax paid on the capital gain. See generally Joel C.  
27 Dobris, *Limits on the Doctrine of Equitable Adjustment in Sophisticated Postmortem Tax*  
28 *Planning*, 66 Iowa L. Rev. 273 (1981).

29  
30 Section 506(a)(3) applies to a qualified Subchapter S trust (QSST) whose income

1 beneficiary is required to include a pro rata share of the S corporation’s taxable income in his  
2 return. If the QSST does not receive a cash distribution from the corporation that is large enough  
3 to cover the income beneficiary’s tax liability, the trustee may distribute additional cash from  
4 principal to the income beneficiary. In this case the retention of cash by the corporation benefits  
5 the trust principal. This situation could occur if the corporation’s taxable income includes capital  
6 gain from the sale of a business asset and the sale proceeds are reinvested in the business instead  
7 of being distributed to shareholders.  
8

9 **Mandatory adjustment.** Subsection (b) provides for a mandatory adjustment from  
10 income to principal to the extent needed to preserve an estate tax marital deduction or charitable  
11 contributions deduction. It is derived from New York’s EPTL § 11-1.2(A), which requires  
12 principal to be reimbursed by those who benefit when a fiduciary elects to deduct administration  
13 expenses on an income tax return instead of the estate tax return. Unlike the New York  
14 provision, subsection (b) limits a mandatory reimbursement to cases in which a marital deduction  
15 or a charitable contributions deduction is reduced by the payment of additional estate taxes  
16 because of the fiduciary’s income tax election. It is intended to preserve the result reached in  
17 *Estate of Britenstool v. Commissioner*, 46 T.C. 711 (1966), in which the Tax Court held that a  
18 reimbursement required by the predecessor of EPTL § 11-1.2(A) resulted in the estate receiving  
19 the same charitable contributions deduction it would have received if the administration expenses  
20 had been deducted for estate tax purposes instead of for income tax purposes. Because a  
21 fiduciary will elect to deduct administration expenses for income tax purposes only when the  
22 income tax reduction exceeds the estate tax reduction, the effect of this adjustment is that the  
23 principal is placed in the same position it would have occupied if the fiduciary had deducted the  
24 expenses for estate tax purposes, but the income beneficiaries receive an additional benefit. For  
25 example, if the income tax benefit from the deduction is \$30,000 and the estate tax benefit would  
26 have been \$20,000, principal will be reimbursed \$20,000 and the net benefit to the income  
27 beneficiaries will be \$10,000.  
28

29 **Irrevocable grantor trusts.** Under Sections 671-679 of the Internal Revenue Code (the  
30 “grantor trust” provisions), a person who creates an irrevocable trust for the benefit of another  
31 person may be subject to tax on the trust’s income or capital gains, or both, even though the  
32 settlor is not entitled to receive any income or principal from the trust. Because this is now a  
33 well-known tax result, many trusts have been created to produce this result, but there are also  
34 trusts that are unintentionally subject to this rule. The Act does not require or authorize a trustee  
35 to distribute funds from the trust to the settlor in these cases because it is difficult to establish a  
36 rule that applies only to trusts where this tax result is unintended and does not apply to trusts  
37 where the tax result is intended. Settlers who intend this tax result rarely state it as an objective  
38 in the terms of the trust, but instead rely on the operation of the tax law to produce the desired  
39 result. As a result it may not be possible to determine from the terms of the trust if the result was  
40 intentional or unintentional. If the drafter of such a trust wants the trustee to have the authority to  
41 distribute principal or income to the settlor to reimburse the settlor for taxes paid on the trust’s  
42 income or capital gains, such a provision should be placed in the terms of the trust. In some  
43 situations the Internal Revenue Service may require that such a provision be placed in the terms  
44 of the trust as a condition to issuing a private letter ruling.  
45

1 [ARTICLE] 6

2 MISCELLANEOUS PROVISIONS

3 SECTION 601. UNIFORMITY OF APPLICATION AND CONSTRUCTION. In

4 applying and construing this Uniform Act, consideration must be given to the need to promote  
5 uniformity of the law with respect to its subject matter among States that enact it.

6 31. It may be desirable to specify whether these principal and income rules are to  
7 be considered rules of construction (that is, governed by the law of the place where  
8 the trust was created or deemed created) or rules of administration (that is, governed  
9 by the law of the situs of the trust from time to time, with appropriate savings  
10 provisions for tax benefits, etc. if the situs is changed). The latter seems to be the  
11 most workable clarification and seems to be contemplated by the change-of-situs  
12 examples in the 2003 amendments to the GST tax regulations (Reg. § 26.2601-  
13 1(b)(4)(i)(E), *Examples 11 & 12*). But authorities are divided. See RESTATEMENT  
14 (SECOND) OF CONFLICT OF LAWS § 268, *Comment h* (1971):

15 “The question of the allocation of receipts and expenditures to principal or income presents a  
16 different problem. See Restatement of Trusts (Second), §§ 232-241. If a testator creates a  
17 trust to be administered in a state other than that of his domicile, the question is whether the  
18 allocation, as for instance of extraordinary dividends, is to be determined by the local law of  
19 his domicile or the local law of the place of administration. This could conceivably be treated  
20 as a question of administration and governed by the local law of the place of administration.  
21 On the other hand, it can be treated as a question of the distribution of the trust property and  
22 governed by the local law of the testator’s domicile. For the purposes of the choice of the  
23 applicable law, it is generally held that it is a question of construction and that the local law of  
24 the testator’s domicile is applicable.”

25 Whether or not that view is “generally held,” does it seem wrong? RDA

26 SECTION 602. SEVERABILITY CLAUSE. If any provision of this [Act] or its

27 application to any person or circumstance is held invalid, the invalidity does not affect other  
28 provisions or applications of this [Act] which can be given effect without the invalid provision or  
29 application, and to this end the provisions of this [Act] are severable.

30 SECTION 603. REPEAL. The following acts and parts of acts are repealed:

31 (1) .....

32 (2) .....

1 (3) .....

2 **SECTION 604. EFFECTIVE DATE.** This [Act] takes effect on .....

3 **SECTION 605. APPLICATION OF [ACT] TO EXISTING TRUSTS AND**

4 **ESTATES.** This [Act] applies to every trust or decedent’s estate existing on [the effective date  
5 of this [Act]] except as otherwise expressly provided in the will or terms of the trust or in this  
6 [Act].

7 **ALTERNATIVE A**

8 **SECTION 606. TRANSITIONAL MATTERS.** Section 409, as amended by this  
9 [amendment], applies to a trust described in Section 409(d) on and after the following dates:

10 (1) If the trust is not funded as of [the effective date of this [amendment]], the date of the  
11 decedent’s death.

12 (2) If the trust is initially funded in the calendar year beginning January 1, \_\_\_\_\_ [insert  
13 year in which this [amendment] takes effect], the date of the decedent’s death.

14 (3) If the trust is not described in paragraph (1) or (2), January 1, \_\_\_\_\_ [insert year in  
15 which this [amendment] takes effect].

16 **ALTERNATIVE B**

17 **SECTION 606. TRANSITIONAL MATTERS.** Section 409 applies to a trust  
18 described in Section 409(d) on and after the following dates:

19 (1) If the trust is not funded as of [the effective date of this [act]], the date of the  
20 decedent’s death.

21 (2) If the trust is initially funded in the calendar year beginning January 1, \_\_\_\_\_ [insert  
22 year in which this [act] takes effect], the date of the decedent’s death.

23 (3) If the trust is not described in paragraph (1) or (2), January 1, \_\_\_\_\_ [insert year in

1 which this [act] takes effect].

2 **END OF ALTERNATIVES**

3 **Legislative Note:** *Use Alternative A if your state has already enacted the Uniform Principal and*  
4 *Income Act. Use Alternative B if your state has not enacted the Uniform Principal and Income*  
5 *Act.*

6  
7 *If your state has not adopted the Uniform Principal and Income Act, use the text of*  
8 *Sections 409 and 505, as amended by these amendments, instead of the text of the previous*  
9 *version of those Sections.*

10

## APPENDIX A

### ISSUES PRESENTED BY UNITRUST CONVERSIONS (Numbering continues from the annotations in the main text.)

#### 32. Origin and use of unitrusts:

The word “unitrust” can be traced at least to the literature of the mid-1960s. Lovell, “The Unitrust: A New Concept to Meet an Old Problem,” 105 TRUSTS & ESTATES 215 (1966); Del Cotto & Joyce, “Taxation of the Trust Annuity: The Unitrust Under the Constitution and the Internal Revenue Code,” 23 TAX L. REV. 257 (1968). An estate planner’s first introduction to the word may be in the term “charitable remainder unitrust” introduced by Congress in section 664, added to the Internal Revenue Code by the Tax Reform Act of 1969. The word was reprised following the enactment of section 2702 in Reg. § 25.2702-3(c), governing “qualified unitrust interests” in grantor retained unitrusts (“GRUTs”) (which are hardly ever used, if they are used at all).

While the precise origin or intent of the word is not totally clear, it appears derived from the notion that the trust consists of a *unified* fund—“a single fund [in which] there would be no distinction between income and principal,” only between “receipts” and “payouts.” Lovell, *supra*. The “unitrust” can be thought of as a trust in which there is a “unity” of interest between the income beneficiary and the remainder beneficiary, because both desire a higher value of the trust assets.

Thus, in today’s legal usage, a “unitrust” is simply a trust in which the periodic payout to the current income beneficiary is determined with reference to a percentage of the net value of the trust assets, determined from time to time, regardless of how much income is produced by the trust assets or the growth of the trust assets. As the value of the trust assets increases, the unitrust amount increases. As the value decreases, the unitrust amount decreases.

By converting or reforming an income trust to a total return unitrust (perhaps the ultimate “adjustment”), the reformation will provide a partnership among the income beneficiaries, the remainder beneficiaries, and the trustee that will enable the trustee to invest the assets for long-term growth to the benefit of all beneficiaries. This will permit the mission of the trustee and investment team to become more focused. Investment decisions can be based on the needs and risk tolerances of the beneficiaries, and there is less likelihood of dissension between the current and future beneficiaries over investment policy. In addition, to the extent that a unitrust approach obviates discretionary invasions of principal, the trustee is protected against challenges by the remainder beneficiaries that any discretionary principal distributions were excessive. Similarly, a unitrust approach eliminates the need to make adjustments between income and principal under section 104 and thus protects the trustee against challenges that such adjustments were improper.

Refinements of the unitrust approach can permit a total return unitrust to even better serve the objective of achieving more stability and predictability for the income beneficiary.



1 One such refinement is to provide that the trust distribute a percentage of its market value  
2 determined on the basis of a two (or more) year rolling average, rather than using the market  
3 value in a single year. Twelve quarters (three years) is a common example. This will reduce  
4 potential fluctuations in distributions caused by short-swing movements in the stock market.  
5 Although the rate of increase in the unitrust distribution to the income beneficiary will lag the  
6 performance of the portfolio, the income beneficiary will benefit in down years. Another  
7 similar refinement designed to reduce risk to all the beneficiaries is to place a ceiling and/or a  
8 floor on the unitrust payout amount, or on the fluctuation of the unitrust amount from year to  
9 year.

10 33. Over one-third of the states (*e.g.*, AL, AZ, CO, FL, IA, ME, MD, MO, NE, NH, NM,  
11 NC, ND, OR, PA, VA, WA, WV, WI) have enacted statutes expressly authorizing conversion to a  
12 unitrust. Virginia’s statute, Code of Virginia § 64.2-1003, which appears after Virginia’s version of  
13 section 104 of the UPIA (Fiduciary’s power to adjust), is reproduced in Appendix C.

14 34. Should such statutory authority be limited to the “examples” [are they really just  
15 “examples”?] in the 2003 amendment to Reg. § 1.643(b)-1 (reproduced in Appendix B) – that is, a  
16 unitrust rate of 3-5 percent, annual but not maybe quarterly smoothing allowed, silent on ceilings and  
17 floors, etc. – cited in Reg. 26.2601-1(b)(4)(i)(D)(2)?

18 35. What factors, if any, should the statute require the trustee to consider in exercising the  
19 power to convert to a unitrust? (Section 104(b) sets forth factors to be considered in exercising the  
20 power to adjust.)

21 36. Should the trustee have a *duty* to convert to a unitrust in certain circumstances?

22 37. Should the trustee have a duty to inform the beneficiaries of the option of converting  
23 to a unitrust?

24 38. Should a trustee who is a beneficiary or otherwise interested be able to convert to a  
25 unitrust? If so, how? With what precautions? (Section 104(c)(5), (6), (7), and (8) and (d) addresses  
26 this in the context of the power to adjust.)

27 39. Should a trustee be able to *release* the power to convert to a unitrust? (Section 104(e)  
28 allows this with respect to the power to adjust.)

29 40. To what extent should a power to convert to a unitrust apply to a trust that was in  
30 existence before that statute was enacted?

31

## APPENDIX B: Treasury Reg § 1.643(b)-1. Definition of income.

For purposes of subparts A through D, part I, subchapter J, chapter 1 of the Internal Revenue Code, “income,” when not preceded by the words “taxable,” “distributable net,” “undistributed net,” or “gross,” means the amount of income of an estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law. Trust provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized. For example, if a trust instrument directs that all the trust income shall be paid to the income beneficiary but defines ordinary dividends and interest as principal, the trust will not be considered one that under its governing instrument is required to distribute all its income currently for purposes of section 642(b) (relating to the personal exemption) and section 651 (relating to simple trusts). Thus, items such as dividends, interest, and rents are generally allocated to income and proceeds from the sale or exchange of trust assets are generally allocated to principal. However, an allocation of amounts between income and principal pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, including ordinary and tax-exempt income, capital gains, and appreciation. **For example, a state statute providing that income is a unitrust amount of no less than 3% and no more than 5% of the fair market value of the trust assets, whether determined annually or averaged on a multiple year basis, is a reasonable apportionment of the total return of the trust. Similarly, a state statute that permits the trustee to make adjustments between income and principal to fulfill the trustee’s duty of impartiality between the income and remainder beneficiaries is generally a reasonable apportionment of the total return of the trust.** Generally, these adjustments are permitted by state statutes when the trustee invests and manages the trust assets under the state’s prudent investor standard, the trust describes the amount that may or must be distributed to a beneficiary by referring to the trust’s income, and the trustee after applying the state statutory rules regarding the allocation of receipts and disbursements to income and principal, is unable to administer the trust impartially. Allocations pursuant to methods prescribed by such state statutes for apportioning the total return of a trust between income and principal will be respected regardless of whether the trust provides that the income must be distributed to one or more beneficiaries or may be accumulated in whole or in part, and regardless of which alternate permitted method is actually used, provided the trust complies with all requirements of the state statute for switching methods. A switch between methods of determining trust income authorized by state statute will not constitute a recognition event for purposes of section 1001 and will not result in a taxable gift from the trust’s grantor or any of the trust’s beneficiaries. A switch to a method not specifically authorized by state statute, but valid under state law (including a switch via judicial decision or a binding non-judicial settlement) may constitute a recognition event to the trust or its beneficiaries for purposes of section 1001 and may result in taxable gifts from the trust’s grantor and beneficiaries, based on the relevant facts and circumstances. In addition, an allocation to income of all or a part of the gains from the sale or exchange of trust assets will generally be respected if the allocation is made either pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of a discretionary power granted to the fiduciary by applicable local law or by the governing instrument, if not prohibited by applicable local law. This section is effective for taxable years of trusts and estates ending after January 2, 2004.

1 **APPENDIX C**

2 **VIRGINIA STATUTE AUTHORIZING CONVERSION TO A UNITRUST**  
3 **(Code of Virginia § 64.2-1003)**  
4

5 § 64.2-1003. Total return unitrust.

6 A. As used in this section:

7 “Disinterested person” means a person who is not a “related or subordinate party,” as that term is  
8 defined in § 672(c) of the Internal Revenue Code (hereinafter referred to in this section as the  
9 “I.R.C.,” and all such references shall include the specific section referred to and any successor  
10 provisions thereof) with respect to the person then acting as trustee of the trust, and excludes the  
11 grantor of the trust and any interested trustee.

12 “Grantor” means an individual who created an inter vivos or a testamentary trust.

13 “Grantor-created unitrust” means a trust created either by an inter vivos or a testamentary instrument  
14 that provides that the trust shall be administered in the manner of a total return unitrust as provided  
15 in this section.

16 “Income trust” means a trust, created by either an inter vivos or a testamentary instrument, that  
17 directs or permits the trustee to distribute the net income of the trust to one or more persons, either in  
18 fixed proportions or in amounts or proportions determined by the trustee, and regardless of whether  
19 the trust directs or permits the trustee to distribute the principal of the trust to one or more such  
20 persons.

21 “Interested distributee” means a person to whom distributions of income or principal can currently be  
22 made who has the power to remove the existing trustee and designate as successor a person who may  
23 be a “related or subordinate party” as defined in I.R.C. § 672(c), with respect to such distributee.

24 “Interested trustee” means (i) an individual trustee to whom the net income or principal of the trust  
25 can currently be distributed or would be distributed if the trust were then to terminate and be  
26 distributed; (ii) any trustee who may be removed and replaced by an interested distributee; or (iii) an  
27 individual trustee whose legal obligation to support a beneficiary may be satisfied by distributions of  
28 income and principal of the trust.

29 “Total return unitrust” means (i) an income trust that has been converted under and meets the  
30 provisions of this section; or (ii) a grantor-created unitrust.

31 “Trustee” means all persons acting as trustee of the trust, except where expressly noted otherwise,  
32 whether acting in their discretion or at the direction of one or more persons acting in a fiduciary  
33 capacity.

34 “Unitrust amount” means an amount computed as a percentage of the fair market value of the trust.

35 B. A trustee, other than an interested trustee, or where two persons are acting as trustees the trustee

1 that is not an interested trustee, or where more than two persons are acting as trustee a majority of the  
2 trustees who are not an interested trustee, may, in his sole discretion and without judicial approval,  
3 (i) convert an income trust to a total return unitrust; (ii) convert a total return unitrust to an income  
4 trust; or (iii) change the percentage used to calculate the unitrust amount or the method used to  
5 determine the fair market value of the trust if:

6 1. The trustee adopts a written policy for the trust providing: (i) in the case of a trust being  
7 administered as an income trust, that future distributions from the trust will be unitrust amounts  
8 rather than net income; (ii) in the case of a trust being administered as a total return unitrust, that  
9 future distributions from the trust will be net income rather than unitrust amounts; or (iii) that the  
10 percentage used to calculate the unitrust amount or the method used to determine the fair market  
11 value of the trust will be changed as stated in the policy;

12 2. The trustee sends notice in a manner authorized under § 64.2-707 of his intention to take such  
13 action, along with copies of such written policy and this section, to (i) the grantor of the trust, if  
14 living; (ii) without regard to the exercise of any power of appointment, the qualified beneficiaries of  
15 the trust then determined under §§ 64.2-701 and 64.2-708, other than the Attorney General; and (iii)  
16 all persons acting as advisor or protector of the trust. The representation provisions of §§ 64.2-714,  
17 64.2-716, 64.2-717, and 64.2-718 shall apply to notice under this subdivision;

18 3. At least one member of each class of qualified beneficiaries receiving notice under clause (ii) of  
19 subdivision 2 is (i) legally competent, (ii) in the case of a charitable organization, then existing, or  
20 (iii) represented in the manner set forth in subdivision 2; and

21 4. No person receiving such notice objects, by written instrument delivered to the trustee, to the  
22 proposed action of the trustee within 30 days of receipt of such notice.

23 C. If there is no trustee of the trust other than an interested trustee, the interested trustee or, where  
24 two or more persons are acting as trustee and are interested trustees, a majority of such interested  
25 trustees may, in his sole discretion and without judicial approval, (i) convert an income trust to a  
26 total return unitrust; (ii) convert a total return unitrust to an income trust; or (iii) change the  
27 percentage used to calculate the unitrust amount or the method used to determine the fair market  
28 value of the trust if:

29 1. The trustee adopts a written policy for the trust providing: (i) in the case of a trust being  
30 administered as an income trust, that future distributions from the trust will be unitrust amounts  
31 rather than net income; (ii) in the case of a trust being administered as a total return unitrust, that  
32 future distributions from the trust will be net income rather than unitrust amounts; or (iii) that the  
33 percentage used to calculate the unitrust amount or the method used to determine the fair market  
34 value of the trust will be changed as stated in the policy;

35 2. The trustee appoints a disinterested person who, in his sole discretion but acting in a fiduciary  
36 capacity: (i) in the case of conversion to a total return unitrust, determines for the trustee (a) the  
37 percentage to be used to calculate the unitrust amount, (b) the method to be used in determining the  
38 fair market value of the trust, and (c) which assets, if any, are to be excluded in determining the  
39 unitrust amount; and (ii) determines for the trustee that conversion is in the best interests of the trust;

1 3. The trustee sends notice in a manner authorized under § 64.2-707 of his intention to take such  
2 action, along with copies of such written policy and this section, to (i) the grantor of the trust, if  
3 living; (ii) without regard to the exercise of any power of appointment, the qualified beneficiaries of  
4 the trust then determined under §§ 64.2-701 and 64.2-708, other than the Attorney General; and (iii)  
5 all persons acting as advisor or protector of the trust. The representation provisions of §§ 64.2-714,  
6 64.2-716, 64.2-717, and 64.2-718 shall apply to notice under this subdivision;

7 4. At least one member of each class of qualified beneficiaries receiving notice under clause (ii) of  
8 subdivision 3 is (i) legally competent, (ii) in the case of a charitable organization, then existing, or  
9 (iii) represented in the manner set forth in subdivision 3; and

10 5. No person receiving such notice objects, by written instrument delivered to the trustee, to the  
11 proposed action of the trustee or the determinations of the disinterested person within 30 days of  
12 receipt of such notice.

13 D. If any trustee desires to convert an income trust to a total return unitrust, convert a total return  
14 unitrust to an income trust, or change the percentage used to calculate the unitrust amount or the  
15 method used to determine the fair market value of the trust but does not have the ability to or elects  
16 not to do it under the provisions of subsection B or C, the trustee may petition the circuit court in  
17 which the trustee qualified, or if there is no such qualification, the circuit court for the jurisdiction in  
18 which the trustee or beneficiary resides, or if the trustee is a corporate trustee and there is no resident  
19 beneficiary, the circuit court where the trust account is administered, for such order as the trustee  
20 deems appropriate. In the event, however, there is only one trustee of such trust and such trustee is an  
21 interested trustee or in the event there are two or more trustees of such trust and a majority of them  
22 are interested trustees, the court, in its own discretion or on the petition of such trustee or trustees or  
23 any person interested in the trust, may appoint a disinterested person who, acting in a fiduciary  
24 capacity, shall present such information to the court as shall be necessary to enable the court to make  
25 its determinations hereunder. Any qualified beneficiary of the trust then determined under §§ 64.2-  
26 701 and 64.2-708, other than the Attorney General, may also petition such circuit court to convert an  
27 income trust to a total return unitrust, convert a total return unitrust to an income trust, or change the  
28 percentage used to calculate the unitrust amount or the method used to determine the fair market  
29 value of the trust assets.

30 E. The fair market value of the trust shall be determined at least annually, using such valuation date  
31 or dates or averages of valuation dates as are deemed appropriate. Any asset for which a fair market  
32 value cannot be readily ascertained shall be valued using such valuation methods as are deemed  
33 reasonable and appropriate. Any such asset may be excluded from valuation, provided all income  
34 received with respect to such asset is distributed to the extent distributable in accordance with the  
35 terms of the governing instrument.

36 F. The percentage to be used in determining the unitrust amount shall be a reasonable current return  
37 from the trust, in any event no less than three percent nor more than five percent, either as provided  
38 by the grantor in the governing instrument in the case of a grantor-created unitrust, or otherwise  
39 taking into account the intentions of the grantor of the trust as expressed in the governing instrument,  
40 the needs of the beneficiaries, general economic conditions, projected current earnings and  
41 appreciation for the trust, and projected inflation and its impact on the trust.

1 G. Following the conversion of an income trust to a total return unitrust, or upon the creation of a  
2 grantor-created unitrust, the trustee:

3 1. Shall treat the unitrust amount as if it were net income of the trust for purposes of determining the  
4 amount available, from time to time, for distribution from the trust, and the distribution of the  
5 unitrust amount shall be considered in full satisfaction of the distribution of all of the net income of  
6 the trust;

7 2. May allocate to trust income for each taxable year of the trust, or portion thereof:

8 a. Net short-term capital gain described in I.R.C. § 1222(5), for such year or portion thereof, but only  
9 to the extent that the amount so allocated together with all other amounts allocated to trust income  
10 for such year or portion thereof does not exceed the unitrust amount for such year or portion thereof;  
11 and

12 b. Net long-term capital gain described in I.R.C. § 1222(7), for such year or portion thereof, but only  
13 to the extent that the amount so allocated together with all other amounts, including amounts  
14 described in subdivision 2 a, allocated to trust income for such year, or portion thereof, does not  
15 exceed the unitrust amount for such year, or portion thereof; and

16 3. Shall treat the unitrust amount as if it were income of the trust for purposes of determining the  
17 amount of trustee compensation where the governing instrument directs that such compensation be  
18 based wholly or partially on income.

19 H. In administering a total return unitrust, the trustee may, in his sole discretion but subject to the  
20 provisions of the governing instrument, determine (i) if the trust is converted to a total return  
21 unitrust, the effective date of the conversion; (ii) the timing of distributions, including provisions for  
22 prorating a distribution for a short year in which a beneficiary's right to payments commences or  
23 ceases; (iii) whether distributions are to be made in cash or in kind or partly in cash and partly in  
24 kind; (iv) if the trust is converted to an income trust, the effective date of such conversion; and (v)  
25 such other administrative matters as may be necessary or appropriate to carry out the purposes of this  
26 section.

27 I. Conversion to a total return unitrust under the provisions of this section shall not affect any other  
28 provision of the governing instrument, if any, regarding distributions of principal.

29 J. Subject to the provisions of the governing instrument, this section shall be construed as pertaining  
30 to the administration of a trust and shall be available to any trust that is administered under Virginia  
31 law, regardless of the date the trust was created, unless:

32 1. The governing instrument reflects an intention that the current beneficiary or beneficiaries are to  
33 receive an amount other than a reasonable current return from the trust;

34 2. The trust is a pooled income fund described in I.R.C. § 642(c)(5), or a charitable-remainder trust  
35 described in I.R.C. § 664(d); or

36 3. The governing instrument expressly prohibits use of this section by specific reference to this

1 section or expressly reflects the grantor’s intent that net income not be calculated as a unitrust  
2 amount. A provision in the governing instrument that “The provisions of § 64.2-1003, Code of  
3 Virginia, as amended, or any corresponding provision of future law, shall not be used in the  
4 administration of this trust,” or “My trustee shall not determine the distributions to the income  
5 beneficiary as a unitrust amount,” or similar words reflecting such intent shall be sufficient to  
6 preclude the use of this section.

7 K. Any trustee or disinterested person who in good faith takes or fails to take any action under this  
8 section shall not be liable to any person affected by such action or inaction, regardless of whether  
9 such person received written notice as provided in this section and regardless of whether such person  
10 was under a legal disability at the time of the delivery of such notice. Such person’s exclusive  
11 remedy shall be to obtain an order of the court directing the trustee to convert an income trust to a  
12 total return unitrust, to convert from a total return unitrust to an income trust, or to change the  
13 percentage used to calculate the unitrust amount.

14 2004, c. 639, § 55-277.4:1; 2009, c. 477; 2012, c. 614.