REVISED UNIFORM PRINCIPAL AND INCOME ACT (1997)

SEVENTH DRAFT

(For the 11/15/96 Drafting Committee Meeting)

[Article] 4

ALLOCATION OF RECEIPTS DURING ADMINISTRATION OF TRUST

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MISCELLANEOUS PROVISIONS

Prefatory Comments

Scope. The prior Uniform Acts, and this Act, contain rules that deal with four areas of trust administration:

- 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 or part of the residue?

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

- 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?

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

The purpose of the Act is to set forth rules that apply to the interests of successive income and remainder beneficiaries. It is not intended to apply to trusts that do not have successive income and remainder beneficiaries, although the Act does not expressly say so. Thus, it is not intended to apply to a trust created to fund a qualified retirement plan, although it has been suggested that there are successive beneficiaries of a trust that funds a retirement plan because the retirees who are presently receiving payments from the trust should be regarded as the income beneficiaries and those who will retire in the future should be regarded as the remainder beneficiaries. And it is an open question whether it does or should apply to an individual retirement account (IRA), which may be formed as either a trust or a custodial (agency) arrangement. Although the vast majority of IRAs (more than 90% of them, I have been told) are formed as custodial arrangements, some lawyers argue that Internal Revenue Code section 408(h), which provides that "For purposes of this section, a custodial account shall be treated as a trust ...," means that they are trusts for local law purposes. This clearly seems incorrect, but it leaves us with the anomalous situation of having two kinds of IRAs, one of which is a trust for local law purposes that is arguably subject to this Act, and one of which is not a trust.

Neither is it intended to apply to a trust or corporation created exclusively for charitable purposes, including one that is established by a private donor as an endowment fund for one or more specific charities. But it has been suggested that Section

103 of this Act might apply to a private endowment, which apparently may be beneficial in some cases because the Uniform Management of Institutional Funds Act does not apply to a fund held for an institution by a trustee that is not an institution (section 1(2) of UMIFA).

How does the Drafting Committee feel about whether this Act should specifically provide that it does or does not apply in some or all of these situations? If there is a provision in this Act that is useful in the administration of a private endowment trust, should those persons who believe that this Act may apply to their situation be able to pursue their theories even though this Act has not been drafted with those trusts in mind? Is the UMIFA problem better solved by an amendment to that Act? And what should we do with IRAs? The individuals who open these accounts are totally unaware of the technical legal relationship that is being created; and the sponsors' computer programs are not designed to track the rules found in a principal and income act. Should we make a point of saying that this Act doesn't apply to IRAs formed as a trust, or should we just leave the sleeping dog where it lies?

REVISED UNIFORM PRINCIPAL AND INCOME ACT (199_)

[Article] 1

DEFINITIONS AND FIDUCIARY DUTIES

SECTION 101. DEFINITIONS.

(a) In this [Act]:

(1) "Accounting period" means a calendar year**[. or other 12-month period selected by the fiduciary.]** The term includes a shorter portion of the accounting period that begins when an income interest begins or ends when an income interest ends.

Note to Drafting Committee - The bracketed material permits a fiduciary to select a 12-month period other than the calendar year as the accounting period while preserving the calendar year as the default in case the fiduciary fails for some reason to select an accounting period. I think there should be a default year, and I think there should be an option to have another year; but I hope we can accomplish that in this definition without having to provide elsewhere that the trustee is required or permitted to select the year.

(2) "Beneficiary" includes, in the case of a decedent's estate, an heir [, legatee,] or devisee and, in the case of a trust, an income beneficiary or a remainder beneficiary.

(3) "Fiduciary" means a personal representative or a trustee. The term includes an executor, administrator, successor personal representative, special administrator, and a person who performs substantially the same function.

(4) "Governing instrument"

means a will, a trust instrument, an instrument exercising a power of appointment, any other instrument that provides for successive income and remainder beneficiaries, or a court order.

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

(6) "Income beneficiary" means a person to whom a trust's net income is or may be payable.

(7) "Income interest" means an income beneficiary's right to receive all or part of the net income whether the governing instrument requires it to be distributed or authorizes it to be distributed in the trustee's discretion

(8) "Mandatory income interest" means an income beneficiary's right to receive net income that the governing instrument requires the fiduciary to distribute.

(9) "Net income" means the total receipts allocated to income during an accounting period minus the disbursements paid and other items transferred from income during that period.

(10) "Principal" means property held in trust for distribution to a remainder beneficiary when the trust terminates, including undistributed income added to principal pursuant to the governing instrument or Section 303.

(11) "Remainder beneficiary" means a person, including another trust, who is entitled to receive principal when an income interest ends.

(12) "Trustee" includes an original, additional or successor trustee, whether or not appointed or confirmed by a court.

(b) Other definitions that apply to this [Act] and the sections in which they appear are:

"Deferred compensation" Section 421(a)

"Due date" Section 304

"Liquidating Asset" Section 422(a)

"Partial liquidation" Section 401(c)

"Periodic due date" Section 304

"Undistributed income" Section 303(b)

Comment

Inventory value. There is no definition for inventory value in this Act because the provisions in which that term was used in the 1962 Act have either been eliminated (in the case of the unproductive property provision) or changed in a way that eliminates the need for the term (in the case of property subject to depletion and the method for determining entitlement to income distributed from a probate estate).

"Discretionary income beneficiary" and "Discretionary income interest" are not defined because those terms are not used in the Act, but the definitions of income beneficiary (section 101(a)(7)) and income interest (section 101(a)(9)) are broad enough to cover both mandatory and discretionary beneficiaries and interests.

SECTION 102. FIDUCIARY DUTIES; GENERAL PRINCIPLES.

(a) In allocating receipts and disbursements to or between principal and income, and in any other matter within the scope of this [Act], a fiduciary:

(1) shall administer a trust or estate in accordance with the provisions of the governing instrument even if there is a different provision in this [Act];

(2) may administer a trust or estate by the exercise of a discretionary power given the fiduciary by the

governing instrument even if the fiduciary's exercise of that power results in a determination different from a provision of this [Act];

(3) shall administer a trust or estate in accordance with the provisions of this [Act] if the governing instrument does not contain a different provision or give the fiduciary a discretionary power;

(4) shall add a receipt or charge a disbursement to principal to the extent that the governing instrument and this [Act] do not provide a rule for allocating the receipt or disbursement to or between principal and income; and

(5) to the extent that the governing instrument and this [Act] do not provide a rule for any matter within the scope of this [Act] other than one governed by paragraph (4), shall administer a trust or estate impartially, based on what is fair and reasonable to all of the beneficiaries, unless the governing instrument clearly manifests an intention that the fiduciary must or may favor one or more of the beneficiaries, and by considering the factors in Section 103(b).

(b) If the governing instrument gives the fiduciary or another person the power to decide whether a receipt or disbursement is principal or income, or to decide any other matter for which there is a provision in this [Act], or provides that this [Act] does not apply but contains no provision about a matter for which there is a provision in this [Act], the fiduciary or other person shall act impartially, based on what is fair and reasonable to all of the beneficiaries, unless the governing instrument clearly manifests an intention that the fiduciary must or may favor one or more of the beneficiaries. A determination in accordance with this [Act] is presumed to be fair and reasonable to all of the beneficiaries.

Comment

Prior Act. Section 102(a) restates the rule in section 2 of the 1962 Act, without changing its substance, to emphasize the fundamental concept that the Act contains only default rules and that provisions in the governing instrument are paramount. If there is no provision in either the governing instrument or this Act, the fiduciary must allocate a receipt or a disbursement to principal, and must be impartial in making any other decision on a matter within the scope of the Act. Section 102(a)(2) incorporates the rule in section 2(b) of the 1962 Act that a discretionary allocation made by the trustee contrary to a rule in the Act should not give rise to an inference of imprudence or partiality by the trustee.

This draft deletes the language at the end of 1962 Act section 2(a)(3) - "and in view of the manner in which men of ordinary prudence, discretion and judgment would act in the management of their affairs" - because persons of ordinary prudence, discretion and judgment, acting in the management of their own affairs don't normally think in terms of the interests of successive beneficiaries. If there is an analogy to an individual's decision-making process, it is probably the individual's decision to spend or to save, but this is not a useful guideline for trust administration. No case has been found in which a court has relied on the 1962 Act's "prudent man" rule.

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

Questions for which there is no provision. The allocation to principal of items for which there is no provision in this Act or the governing instrument, as provided in subsection (a)(4), will favor the income beneficiary in the year allocated to principal if the item is a disbursement, but thereafter it will reduce the income produced by principal. If the item is a receipt, it will favor the income beneficiary by increasing the annual income, and will eventually, upon termination of the trust, favor the remainder beneficiary. Allocating such items to principal implements the general rule, which is to administer the trust impartially, based on what is fair and reasonable to both income and remainder beneficiaries.

Duty of impartiality. Governing instruments occasionally provide that the trustee, or an accountant engaged by the trustee, or a committee of persons who may be family members or business associates, shall have the power to determine what is income and what is principal; they may also provide that the Act does not apply without saying how the trustee should deal with a matter provided for in the Act. The provision in Section 102(b) is intended to be a statement of public policy that in such cases the rule of impartiality applies if the governing instrument does not provide that one or more beneficiaries are to be favored. The fact that a person is named an income beneficiary or a remainder beneficiary is not by itself an indication of partiality for that beneficiary.

SECTION 103. TRUSTEE'S POWER TO ADJUST WHEN THE TRUST INSTRUMENT IS SILENT.

(a) In a case in which a trustee determines that the trust instrument does not contain adequate discretionary powers of administration, or powers to invade principal or accumulate income, that are sufficient to permit the trustee to comply with the trustee's duty to pay due regard to the interests of income and principal and the duty of impartiality, the trustee shall have the power to adjust between principal and income in such amounts and proportions as the trustee considers necessary to administer the trust impartially, based on what is fair and reasonable to all of the beneficiaries, unless the governing instrument clearly manifests an intention that the fiduciary must or may favor one or more of the beneficiaries.

(b) In adjusting trust assets a trustee shall consider the following factors:

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

(2) the express intent of the settlor;

(3) the identity and circumstances of the beneficiaries;

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

(5) the anticipated tax consequences of an

adjustment;

(6) the total return from investments;

(7) needs for liquidity, regularity of income, and preservation and appreciation of capital;

(8) the assets held in the trust; and

(9) other factors relevant to the trust or its beneficiaries.

(c) A trustee may not make an adjustment that would cause a loss of all or part of a federal or state gift tax exclusion; gift or estate tax marital deduction; income, gift or estate tax charitable deduction; or inheritance tax deduction, if the exclusion or deduction is otherwise available to any estate or trust or to the settlor of a trust or a decedent.

(d) A trustee may not make an adjustment for the trustee's direct or indirect benefit, including the satisfaction or mitigation of any legal obligation of the trustee. However, a disinterested co-trustee may make the adjustment.

(e) If a governing instrument limits the power of a trustee to make equitable adjustments, the instrument is not contrary to this section unless it is clear from the instrument that it is intended to deny the trustee this power of adjustment.

Comment

Purpose and Scope of Provision. This section provides a power to adjust total return. This section does not provide a power to reduce a beneficiary's income or a power to invade principal or a power to distort trust administration for improper tax advantage. An adjustment of investment return under this section is not an invasion of principal or an accumulation of income. It is an adjustment of the total return received by the trustee. Thus, this section can alleviate the tension between modern rules for investing the assets held by a trustee and traditional ideas about what constitutes the return on a portfolio. As to modern trust investing, see the Uniform Prudent Investor Act (1994). As to the allocation of return in a modern context see, Joel C. Dobris, "New Forms of Private Trusts for the 21st Century -- Principal and Income." __ Real Property, Probate & Trust Journal __; Joel C. Dobris, Real Return, Modern Portfolio Theory and College, University and Foundation Decisions on Annual Spending From Endowment: A Visit to the World of Spending Rules 28 Real Prop., Prob., & Tr.J. 49 (1993); Joel C. Dobris, The Probate World at the End of the Century: Is a New Principal and Income Act in Your Future? 28 Real Prop., Prob., & Tr.J. 393 (1993).

This section allows the trustee to undertake the best, the most prudent and totally most productive investment of all the trust assets without concern about whether the investments chosen have the effect of impartially allocating the total investment return between the income and principal beneficiaries. This section also allows the trustee to follow the well understood traditional system of allocating receipts and expenditures in most situations.

If the trustee invests all the assets of a trust, taken as a portfolio, in a way that will have an initially unsuitable effect under the terms of the trust without an adjustment of return this section allows the trustee to adjust. The power to adjust spares the trustee from having to choose second best investments.

Giving some trustees the power to adjust portfolio returns between income and principal is less dramatic than it might first seem to be. The prior Principal and Income Acts inferentially allowed a range of possible returns for successive beneficiaries via asset choice and asset allocation. There were a number of legally acceptable, impartial portfolios for any given trust that would produce a variety of income and principal outcomes. The trustee always had the power to affect the return to beneficiaries.

Operating under this section, if the trustee concludes that the outcome of a conventional allocation between principal and income would be unsuitable, then the trustee should adjust to achieve a suitable result.

Fiduciary duty. This power is subject to an abuse of discretion standard. Reasonable trustee action is not subject to judicial review except to prevent an abuse of discretion. See Restatement (Second) of Trusts 187 (1959). See also id 183, 232, 233, comment p (1959).

There is an intrinsic tension in trust law between granting trustees broad powers that facilitate flexible and efficient trust administration, and protecting trust beneficiaries from the misuse of such powers. A broad trustee's power, such as those found in most lawyer-drafted instruments and exemplified in the Uniform Trustees' Powers Act, permits the trustee to act vigorously and expeditiously to maximize the interest of the beneficiaries in a variety of transactions and administrative settings. Trust law relies upon the duties of loyalty, impartiality and prudent administration, and upon procedural safeguards such as periodic accounting and the availability of judicial oversight, to prevent the misuse of such powers. Adjustment, which is a species of trustee power, raises the same tension. If the trustee adjusts effectively, the beneficiaries obtain the advantage of the underlying investment and the adjustment. But if the trustee adjusts ineffectively the adjustment can do harm.

This section is designed to strike the appropriate balance not only between the advantages and the hazards of adjustment, but also between the advantages and hazards of reworking a known investment/allocation system.

This section is designed to provide a power to adjust total return and not to provide a power to reduce a beneficiary's income or a power to invade principal. An adjustment of investment return under this section is not an invasion of principal or an accumulation of income, but an adjustment of the total return received by the trustee. It is a provision to cure an oversight on the part of the settlor and the drafter.

This section is subject to the injunctions in Section 102 of this Act including the one that the trustee "shall be fair and reasonable to all of the beneficiaries unless the governing instrument clearly manifests an intention that the fiduciary must or may favor one or more beneficiaries." This section is also subject to the limitations on fiduciary liability in Section 103.

Default rule. This section is a default rule of trust law. A settlor can expressly set aside this rule, just as a settlor can establish a noncharitable unitrust, instead of a traditional trust, to avoid some of the problems that arise when a trustee invests in a modern fashion within a traditional trust.

Examples. The following examples demonstrate the function of the adjustment approach, primarily in the context of modern investing:

Example (1)--T is the trustee of a trust that provides income for A for life, remainder to B. The trustee originally holds a portfolio invested 20% in equity and 80% in debt. In response to the Uniform Prudent Investor Act, the trustee converted this portfolio to one invested 50% in equity and 50% in debt. As a result, the current yield, as determined under other sections of this act, falls. The trustee is authorized, after considering the factors in this section, to transfer from principal to income, such amounts as the trustee considers appropriate to increase the income interest.

Example (2)--T was the trustee of a trust that provides income for C for life, remainder to D. In a period of intense inflation, when debt investments yielded double digit returns, the trustee determined that a portion of this nominal double digit interest, payable to C under the other provisions of this Act, was a return of capital. The trustee properly transferred a portion of this nominal interest to principal as compensation for the loss of value of principal due to inflation. The trust was not a marital deduction trust.

Example (3)--T is the trustee of a trust that provides income for E for life, remainder to F. The trust also gives the trustee the power to invade principal for the benefit of E for "dire emergencies only." This is a trust instrument that does not contain adequate discretionary powers to invade principal sufficient to permit the trustee to comply with the trustee's duty to pay due regard to the interests of income and principal and the duty of impartiality. The trustee has the power contained in this section to adjust between principal and income. See generally Joel C. Dobris, "New Forms of Private Trusts for the 21st Century -- Principal and Income." __ Real Property, Probate & Trust Journal __; Joel C. Dobris, Real Return, Modern Portfolio Theory and College, University and Foundation Decisions on Annual Spending From Endowment: A Visit to the World of Spending Rules 28 Real Prop., Prob., & Tr.J. 49 (1993); Joel C. Dobris, The Probate World at the End of the Century: Is a New Principal and Income Act in Your Future? 28 Real Prop., Prob., & Tr.J. 393 (1993); Joel C. Dobris, Limits on the Doctrine of Equitable Adjustment in Sophisticated Postmortem Tax Planning, 66 Iowa L. Rev. 273 (1981). See also James P. Garland, A Market-Yield Spending Rule for Endowments and Trusts, The Financial Analysts Journal, 50 (July/Aug 1989).

Example (4)--T is the trustee of a trust that gives the trust income to G for life, remainder to H. The trust allows the trustee to invade the principal of the trust, over the lifetime of the trust, in the discretion of the trustee, to a maximum of 6% of the value of the trust at its inception, for the benefit of G. The trustee does not have the power contained in this section to adjust between principal and income. This power of invasion is such that the settlor is understood to have considered traditional principal as a source of resources for the income beneficiary and capped it in an exact and precise fashion. Therefore, the power of adjustment is unavailable.

Example (5)--Having invested in assets generating no traditional income, the trustee chose to sell enough assets to generate a return for the income beneficiary. In adjusting, the trustee chose to consider as a factor a system used by some colleges and universities for determining current return on endowment in determining trust income. In doing so, the trustee took into account the different purposes, time horizons and tax exempt status of such organizations and the potential for additional gifts lacking in a private trust. T gave the income beneficiary an amount equal to 30% of 4.5 percent of the principal of the trust plus 70% of the amount paid in the prior year to the income beneficiary. This is a proper exercise of the power of adjustment because it takes into account beneficiary expectations and the inflation adjusted return on investments, and because it makes efficient and proper use of the expertise of professionals who closely study the annual return on investment assets. See Joel C. Dobris, Real Return, Modern Portfolio Theory and College, University and Foundation Decisions on Annual Spending From Endowments: A Visit to the World of Spending Rules 28 Real Prop., Prob., & Tr.J. 49 (1993).

Example (6)--Having invested in assets generating no traditional income, in adjusting the trustee chose to consider as a factor the National Association of College and University Business Officers (NACUBO) average endowment spending rate for college and university endowments for the previous year. In doing so, the trustee took into account the different purposes, time horizons and tax exempt status of such organizations and the potential for additional gifts lacking in a private trust. This is a proper exercise of the power of adjustment because, among other things, it makes efficient and proper use of the expertise of professionals who closely study the annual return on investment assets. See Twentieth Century Fund, Task Force on College and University Endowment Policy, Funds for the Future 122 (1975) (this is, in its essence, a monograph by J. Peter Williamson). See also Robert H. Jeffrey, The Folly of Market Timing, Harv. Bus. Rev., July-Aug 1984, at 102; Robert H. Jeffrey, A New Paradigm for Portfolio Risk, J. Portfolio Mgmt., Fall 1984, at 33.

Example (7)--T is the trustee of a trust that provides income for I for life, remainder to J. The trust was created primarily for tax savings purposes. In response to a request from I, the trustee proposes to use this section to accumulate traditional trust income to reduce I's assets for transfer tax purposes. T is not authorized to make this adjustment under this section. The settlor is understood as not intending this result and it cannot be justified by reference to the factor in Section 103(b)(2) ("the anticipated tax consequences of an adjustment").

Example (8)--T is the trustee of a trust that provides income to L for life, remainder to M. The trust is a tax advantaged trust. Receipts allocated to principal are subject to transfer taxation at the termination of the trust. T proposes to allocate a traditional principal receipt to income under this section to avoid transfer taxes at the termination of the trust. Such an adjustment is not authorized by this section. The settlor is understood not to have intended such a result and it cannot be justified by reference to the factor in Section 103(b)(2) ("the anticipated tax consequences of an adjustment").

Subsection (c). Subsection (c) is designed to preserve the tax benefits sought by settlors in trusts created before and after the enactment of this Act.

Subsection (d). Subsection (d) deals with trust provisions forbidding trustees from making equitable adjustments. Ultimately, the effect of any provision in a document is a question of interpretation. Ordinarily, a clause that restrains the use of equitable adjustments is not to be read as disallowing the use of this equitable power of adjustment. Ordinarily, a clause that is in an instrument drafted before the promulgation of this Act is not to be construed as forbidding the use of this equitable power of adjustment. See generally, Joel C. Dobris, Limits on the Doctrine of Equitable Adjustment in Sophisticated Postmortem Tax Planning, 66 Iowa L. Rev. 273 (1981).

[Article] 2
DECEDENTS' ESTATES AND TERMINATING INCOME INTERESTS

SECTION 201. DETERMINATION AND DISTRIBUTION OF NET INCOME.

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

(1) A fiduciary of an estate or terminating income interest shall determine the amount of net income and net principal receipts received from property specifically given to a beneficiary under the rules in [Articles] 3 through 5 that apply to trustees and the rules in paragraph (4). The fiduciary shall distribute the net income and net principal receipts to the beneficiary who is to receive the specific property.

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

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

(ii) paying from principal all disbursements made or incurred in connection with the settlement of a decedent's estate or the winding up of a terminating income interest, including debts, funeral expenses, family allowances, fees of attorneys, accountants and fiduciaries, court costs, and death taxes and related penalties that are apportioned to the estate or terminating income interest by the governing instrument or applicable law; and

(iii) distributing from net income, or from principal to the extent that net income is insufficient, to a nontrust beneficiary who is to receive a pecuniary amount outright, the amount, if any, provided by applicable law or the governing instrument. If the pecuniary amount is required to be paid from a trust after an income interest ends, and if there is no applicable law or governing instrument provision, the fiduciary shall distribute the amount, if any, to which the beneficiary would be entitled under applicable law if the pecuniary amount were required to be paid under a will.

(3) A fiduciary shall distribute the remaining net income to all other beneficiaries, including a trust that receives a pecuniary amount, in the manner described in Section 202. This paragraph applies to a trust that receives a pecuniary amount even if a beneficiary of the trust holds a presently exercisable general power of appointment over the trust, including an unqualified power to withdraw assets.

(4) A fiduciary may not reduce income or principal receipts from property described in paragraph (1) because of a payment described in Sections 501 or 502 to the extent that the governing instrument or applicable law requires the fiduciary to make the payment from assets other than the property or to the extent that the fiduciary recovers or expects to recover the payment from a third party. The property's net income and principal receipts are determined by including all of the amounts the fiduciary receives or pays with respect to the property, whether those amounts accrued or became due before, on, or after the date of a decedent's death or an income interest's terminating event, and by making a reasonable provision for amounts that the fiduciary believes the trust may become obligated to pay after the property is distributed.

(5) For the purposes of this Act, an income interest ends when an income beneficiary dies or another terminating event occurs. The rules that apply when an income interest ends also apply at the end of a period during which there is no beneficiary to whom a trustee may or must distribute principal or income.

Comment

To the Drafting Committee: One member of our group has commented that he believes definitions of "successive income interest" and "terminating income interest" (or "terminating trust") are unnecessary - that the terms can be used without definition because their meaning is obvious. The suggestion to eliminate the definitions reinforces my desire to simplify the Act as much as possible, but I don't share the view that these terms are obvious in all fact situations. If the definitions are deleted, I would add the comment that follows this one (in fact, I would probably add it even if you decide not to delete them). What do you think? Are definitions needed, or is the comment sufficient? The deleted definitions (from old section 201) read as follows:

(a) "Successive income interest" means an income interest in some or all of the principal assets that were subject to an income interest that has ended. It may follow an income interest in the same trust or it may be an income interest in another trust that receives some or all of the principal assets subject to a terminating income interest.

(b) "Terminating income interest" means an income interest that has partially or completely ended, and whose assets become subject to one or more successive income interests or are to be distributed free of trust, or both, after administration of the assets subject to the income interest has been completed.

Terminating income interests and successive income interests. A basic trust has a single income beneficiary, and the trust ends when the income interest ends. More complex trusts have a number of income interests, which may be concurrent or successive, but they are interests in a single trust and are not separate trusts. For that reason, the Act speaks in terms of income interests ending and beginning rather than trusts ending and beginning. When a trust's income interest ends, the trustee's powers continue during the winding up period required to complete its administration. A terminating income interest is one that has ended but whose administration is not complete.

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

If the assets that are subject to a terminating income interest pass to another trust because the income beneficiary exercises a general power of appointment over the trust assets, the recipient trust would be a "new" trust; and if she exercises a limited power of appointment over the trust assets it might be a new trust in some states (see Austin W. Scott and William F. Fratcher, 5A The Law of Trusts § 640, at 483 (4th ed. 1989)). But for purposes of this Act a new trust is also a successive income interest.

______**Pecuniary bequests.** The different treatment (in paragraphs (2)(iii) and (3) of this section) for an outright pecuniary bequest and a pecuniary bequest in trust is taken from Section 5(b)(2) of the 1962 Act.

Interest on pecuniary bequests. Section 201(2)(iii) provides that the beneficiary of an outright pecuniary amount is to receive the interest or other amount provided by applicable law, and it adds a provision to cover the situation in which there is a provision under applicable law or a governing instrument dealing with gifts made under a will but no provision dealing with gifts made under an inter vivos trust agreement.

Section 3-904 of the Uniform Probate Code provides: "General pecuniary devises bear interest at the legal rate beginning one year after the first appointment of a personal representative until payment, unless a contrary intent is indicated by the will." There is no comparable provision in the UPC that deals with gifts made in an inter vivos trust agreement. The various state authorities that provide for the amount that a beneficiary of an outright pecuniary amount is entitled to receive are collected in Richard B. Covey, Marital Deduction and Credit Shelter Dispositions and the Use of Formula Provisions, App. B (Supp. 1995).

SECTION 202. DISTRIBUTIONS TO RESIDUARY AND REMAINDER BENEFICIARIES.

(a) Each beneficiary described in Section 201(3) shall receive a percentage of the net income equal to the beneficiary's percentage interest in undistributed principal assets other than property specifically given to a beneficiary and property required to pay pecuniary amounts not in trust, using values as of the distribution date.

(b) If a fiduciary makes more than one distribution of assets to beneficiaries to whom this section applies, all of those beneficiaries, including those who do not receive part of the distribution, are entitled, as of each distribution date, to the net income the fiduciary has received after the date of death or terminating event or earlier distribution date but has not distributed as of the current distribution date. In determining a beneficiary's share of net income:

(1) the beneficiary shall receive a percentage of the net income equal to the beneficiary's percentage interest in the undistributed principal assets immediately before the distribution date, including assets that later may be sold to meet principal obligations; and

(2) the beneficiary's interest in the undistributed principal assets must be computed on the basis of the aggregate value of those assets as of the distribution date without reducing the value by any unpaid principal obligation. For the purpose of this section, the distribution date is the date as of which the fiduciary computes the value of the assets, which may be a date reasonably near the date on which assets are actually distributed.

(c) The rules in this section shall apply to net gain or loss realized after the date of death or terminating event or earlier distribution date from the disposition of a principal asset if this section applies to the income from the asset.

(d) If a fiduciary does not distribute all of the collected but undistributed net income, gain or loss to each person on a distribution date, the fiduciary shall maintain appropriate records showing the interest of each beneficiary in that net income, gain or loss.

Comment

Relationship to prior Acts. Section 202 retains the concept in Section 5(b)(2) of the 1962 Act that the residuary legatees of estates are to receive net income earned during the period of administration on the basis of their proportionate interests in the undistributed assets when distributions are made. It changes the basis for determining the proportionate interests by using asset values as of a date reasonably near the time of distribution instead of inventory values; it extends the application of these rules to distributions from terminating trusts; and it extends these rules to gain or loss realized from the disposition of assets during administration, an omission in the 1962 Act that has been noted by a number of commentators.

[Article] 3

APPORTIONMENT AT BEGINNING AND END OF INCOME INTEREST

SECTION 301. WHEN RIGHT TO INCOME BEGINS.

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

(b) An asset becomes subject to a trust:

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

(2) on the date of an individual’s death in the case of an asset that is transferred to a fiduciary by a third party because of the individual’s death;

(3) on the date of death of a testator in the case of an asset that becomes subject to a trust by reason of a will, even if

there is an intervening period of administration of the testator's estate.

(c) An asset becomes subject to a successive income interest on the date the preceding income interest ends, even if there is an intervening period of administration to wind up the preceding income interest.

SECTION 302. APPORTIONMENT OF RECEIPTS AND DISBURSEMENTS WHEN DECEDENT DIES OR INCOME INTEREST BEGINS.

(a) A receipt or disbursement must be allocated to principal if its due date occurs before a decedent dies or an income interest begins.

(b) A receipt or disbursement whose due date occurs after the date on which a decedent dies or an income interest begins shall not be apportioned between principal and income if the due date is a periodic due date under Section 304. If it is not a periodic due date, the receipt or disbursement must be treated as accruing from day to day. The portion of the income or obligation accruing before the income interest begins is principal and the balance is income.

Comment

Prior Acts. Professor Bogert stated that "Section 4 of the [1962] Act makes a change with respect to the apportionment of the income of trust property not due until after the trust began but which accrued in part before the commencement of the trust. It treats such income as to be credited entirely to the income account in the case of a living trust, but to be apportioned between capital and income in the case of a testamentary trust. The [1931] Act apportions such income in the case of both types of trusts, except in the case of corporate dividends." Bogert, The Revised Uniform Principal and Income Act, 38 Notre Dame Law 50, 52 (1962). The 1962 Act accomplishes this result by providing in Section 4(b) that the Act applies "in the administration of a decedent's estate or an asset becoming subject to a trust by reason of a will...," and in Section 4(c) that "[i]n all other cases, any receipt from an income-producing asset is income even though ... earned or accrued in whole or in part before the date when the asset became subject to the trust."

Having two different rules is confusing. In order to simplify administration, Section 302 applies the same rule to inter vivos trusts (revocable and irrevocable), testamentary trusts and assets that become subject to an inter vivos trust through a pour-over bequest in a will.

Periodic payments. Under section 302, a periodic payment is principal if it is due but unpaid before a decedent dies or before an asset becomes subject to a trust, but the next payment is allocated entirely to income and is not apportioned. Thus, periodic receipts such as rents, dividends, interest, and annuities, and disbursements such as mortgage payments, are not apportioned. This is the original common law rule. Edwin A. Howes, Jr., The American Law Relating to Income and Principal 70 (1905). In trusts in which a surviving spouse is dependent upon a regular flow of cash from the decedent's securities portfolio, this rule insures that payments to the spouse will continue at the same level as before the settlor's death. Under the 1962 Act rule, the predeath portion of the first periodic payment due after death is apportioned to principal in a testamentary trust.

Nonperiodic payments. Under the second sentence of subsection (b), interest on an obligation that does not provide a due date for the interest payment, such as interest on an income tax refund, would be apportioned to principal to the extent that it accrues before a person dies or a trust begins unless the obligation is specifically given to a devisee or remainder beneficiary, in which case subsection 201(1) would give all of the accrued interest to the person who receives the obligation.

SECTION 303. APPORTIONMENT OF RECEIPTS AND DISBURSEMENTS WHEN INCOME INTEREST ENDS.

(a) When a mandatory income interest ends, a mandatory income beneficiary who survives that date, or the estate of a deceased mandatory income beneficiary whose death causes the interest to end, is entitled to the beneficiary's share of the undistributed income that is not disposed of by the governing instrument to the extent that the beneficiary does not have an unqualified power to revoke the trust when the income interest ends.

(b) When a trustee's obligation to pay an annuity or a unitrust amount ends, the trustee shall pay a pro rata portion of the annuity or unitrust amount, as determined under applicable law, if it is necessary to do so to qualify for an income, gift, estate, or other tax deduction. In all other cases, an annuity payment or unitrust amount shall not be apportioned.

(c) "Undistributed income" means net income received before the last distribution date prior to the date on which an income interest ends, but to the extent necessary for a trust to qualify for the marital deduction, the term means net income received before the date on which an income interest ends. The term does not include an item of income or expense that is due or accrued, net income from property to which Section 201(1) applies, or net income that has been added or is required to be added to principal pursuant to the terms of the governing instrument.

[Alternate provision for the first sentence in subsection (c): "Undistributed income means net income received before the date on which an income interest ends."]

Comment

Prior Acts. Both the 1931 Act (Section 4) and the 1962 Act (Section 4(d)) provide that a deceased income beneficiary's estate is entitled to the undistributed income. The Drafting Committee concluded that this is probably not what most settlors would want, and that most settlors would probably favor the income beneficiary first, the remainder beneficiaries second, and the income beneficiary's heirs last, if at all. However, it decided not to eliminate this provision completely to avoid causing disputes about whether the trustee should have distributed collected cash before the income beneficiary died.

The prior Acts include in undistributed income periodic payments, other than dividends, that are due or that have accrued; the last sentence of subsection (c) provides that such items are not included in undistributed income. That provision would apply to periodic payments of interest, rent, and dividends, and also to unrealized increases in the value of zero coupon bonds and similar instruments.

Beneficiary with an unqualified power to revoke. Subsection (a) does not apply to a beneficiary who has an unqualified power to revoke the trust when the income interest ends. Without this limitation, subsection (a) would apply to a revocable living trust whose grantor is the mandatory income beneficiary during her lifetime, and whose will provides that all of the assets in the probate estate are to be distributed to the trust. This limitation would also apply to a trust created by someone other than the income beneficiary if the trust permits the beneficiary to withdraw all or a fraction of the trust principal after attaining a specified age and the beneficiary attains that age but fails to withdraw all of the principal that she is permitted to withdraw. The limitation applies in this case on the assumption that the beneficiary has either provided for the disposition of the trust assets (including the undistributed income) by exercising a power of appointment that she has been given, or has not withdrawn the assets because she is satisfied to have the principal and undistributed income of the trust be distributed to the persons designated in the trust instrument as takers in default. If this beneficiary has the power to withdraw 25% of the trust principal, subsection (a) would apply without limitation to the 75% that she cannot withdraw.

Marital deduction trusts. There are two kinds of marital deduction trust to which the first alternate language in section 303(c) would apply. One is the general power of appointment trust, provided for in IRC § 2056(b)(5), and the other is the qualified terminable interest property (QTIP) trust, provided for in IRC § 2056(b)(7). The requirements that must be met for these two trusts with respect to undistributed income are different: The IRS regulations require that the trust instrument for a power of appointment trust must provide for undistributed income to be subject to the spouse's power of appointment or that it go to the spouse's estate; but the regulations do not require the undistributed income to go to the spouse's estate if it is subject to her general power. Under the QTIP regulations, undistributed income is not required to pass to the spouse's estate or be subject to a power of the spouse because, by statute, that income is automatically included in the spouse's estate. Hence the "to the extent that" language in the first alternate provision.

SECTION 304. WHEN INCOME OR OBLIGATIONS ARE DUE. An item of income or an obligation is due on the date on which the payor is required to make a payment. If there is no stated payment date, there is no due date for the purposes of this [Act]. Corporate distributions to stockholders are deemed to be due on the date fixed by the corporation for determination of stockholders of record entitled to distribution or, if no date is fixed, on the declaration date for the corporate distribution. A due date for a recurring receipt or disbursement, including rent, interest, or a distribution from an entity, is periodic if recurring payments are provided for in a lease or an obligation to pay interest or if the entity customarily makes distributions at regular intervals.

[Article] 4

ALLOCATION OF RECEIPTS DURING ADMINISTRATION OF TRUST

[Part] 1

Distributions From Entities

SECTION 401. CHARACTER OF DISTRIBUTIONS.

(a) Except as otherwise provided in this Section, all distributions of cash from an entity are income.

(b) Distributions from an entity that are principal include:

(1) a distribution of property other than cash, except as provided in paragraph (4);

(2) a distribution or series of related distributions of cash or cash and property in exchange for part or all of a trust's interest in the entity;

(3) a distribution in total or partial liquidation of the entity; and

(4) a distribution of cash or property from an entity that is a regulated investment company or a real estate investment trust if it is a capital gain dividend for federal income tax purposes.

(c) "Partial liquidation" means:

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

(2) a distribution or series of related distributions of cash or of cash and property in a total amount greater than [20] percent of the entity's gross assets, as shown by the entity's year-end financial statements immediately preceding the initial distribution.

(d) A distribution of cash is not a partial liquidation, nor shall it be taken into account under subsection (c)(2), to the extent that it does not exceed the amount of the income tax obligation that a beneficiary must pay on part or all of the entity's undistributed taxable income.

(e) A trustee may rely upon a statement made by an entity about the source or character of a distribution if the statement is made at or near the time of distribution by the distributing entity's board of directors or other person or group of persons authorized to exercise powers of distribution comparable to those of a corporation's board of directors.

(f) This Section applies to distributions from a corporation, partnership, limited liability company, regulated investment company, real estate investment trust, common trust fund, and any other organization in which the trustee owns an interest other than a trust or estate to which Section 402 applies.

Comment

Capital gain dividends. The provision in the 1962 Act has been extended to apply to distributions from real estate investment trusts (REITs). Under the Internal Revenue Code and the Income Tax Regulations, a "capital gain dividend" from a mutual fund or REIT is the excess of the fund's net long-term capital gain over its net short term capital loss. As a result, a capital gain dividend does not include any net short-term capital gain, and those gains are treated as income.

Reinvested dividends. If a trustee elects (or continues an election made by its predecessor) to reinvest dividends in shares of stock of a distributing corporation or fund, whether evidenced by new certificates or entries on the books of the distributing entity, the new shares would be principal, but the trustee may consider whether an adjustment under Section 103 is appropriate as a result.

Distributions of property. The 1962 Act describes a number of types of property that would be principal if distributed by a corporation. This becomes unwieldy in a section that applies to both corporations and all other entities. By stating that principal includes the distribution of any property other than cash, Section 401 embraces all of the items enumerated in Section 6 of the 1962 Act as well as any other form of noncash distribution not specifically mentioned in that Act.

Partial liquidations. Under Subsection (c), any cash distribution designated by the entity as a partial liquidating distribution is principal regardless of the percentage of total assets that it represents, but distributions in excess of 20% of the entity's gross assets are partial liquidations even though the entity doesn't describe them as such or it describes them as an ordinary dividend.

If the distribution or distributions include both property and cash, and if property is a more significant part of the amount distributed than is the cash, the trustee may feel that some portion of the cash distribution should be treated as an ordinary dividend, especially if the entity has characterized part or all of the cash as a dividend distribution. The trustee has the authority under Section 103 to adjust between principal and income to the extent the trustee decides that the rule in Section 401(c) results in too large an allocation to principal.

Distributions to pay taxes. In computing whether a distribution is larger than 20% of the gross assets, the portion of the distribution that is needed by a beneficiary to pay income tax on the entity's taxable income is ignored, and the 20% computation would be made based on the amount distributed in excess of the amount needed to pay the income tax.

NOTE TO THE DRAFTING COMMITTEE: Two alternatives follow. The first is to include the following subsection in the text of the Act. The second is to deal with the subject matter in a comment. Which approach do you prefer?

[ALTERNATIVE ONE][Insert the following as subsection (c), and redesignate present (d) and (e) as (e) and (f)]

(d) To the extent that the total amount of a distribution or a series of related distributions described in subsection (c) is more than [10] percent but not more than [20] percent of the entity’s gross assets, a trustee may determine the extent to which all or a part of the distribution shall be treated as a partial liquidation by taking into account factors that the trustee considers relevant, including the extent to which the entity's cash was derived from its regular business operations, the liquidation of an investment asset or of a business asset not held for sale to customers in the normal course of its business, or an asset to which other sections of this [Act] would apply if it were owned directly by the trustee.

[ALTERNATIVE TWO][Insert the following comment and omit any statutory reference to the subject matter]

Other large distributions. Some cash distributions may be quite large (for example, more than 10% but not more than 20% of the entity's gross assets) and have characteristics that suggest they should be treated as principal rather than income. For example, an entity may have received cash from sources other than its normal business operations because it sold an investment asset, or a business asset other than one held for sale to customers in the normal course of its business and did not replace it, or it borrowed a large sum of money and secured the repayment of the loan with a substantial asset, or a principal source of its cash was from assets such as mineral interests, the net income from which would have been principal if the trust had owned the assets directly instead of indirectly through an entity. The trustee has the authority in such a case under Section 103 to make an adjustment between income and principal to take these factors into account, although Section 103(c) may prevent an adjustment in the case of a marital deduction trust] **[End of Alternative Two]**

Distributions of stock in another entity. Distributions of property to a trustee are more easily accounted for as principal than as income because most fiduciary accounting systems are not designed to show any kind of asset other than cash as part of the income account. However, if the trustee believes that allocating a particular non-cash distribution to principal is inappropriate in a particular situation, an adjustment can be made under Section 103.

Entities to which section 401 applies. New entities, or new names for old entities, appear with some regularity. The Internal Revenue Code has given us REMICs (real estate mortgage investment conduits), and most recently FASITs (financial asset securitization investment trusts), but the Code provides that both can be "any entity" that makes an election to be a REMIC or a FASIT and meets certain other requirements. The interest an investor receives in a

REMIC or a FASIT is an interest in a pool of underlying mortgages or other debt instruments and the right to receive a pro rata portion of the interest and principal payments from those underlying assets. Other securitization arrangements, unblessed by formal Congressional recognition, seem to be born almost daily, each with a distinctive acronym. Even if it were possible to capture them all in this kind of an Act, the list would be obsolete within a matter of days after it was completed. The best we can hope for is that the principles set down in this and other sections of the Act will provide trustees with sufficient guidance that they can make the appropriate decisions about how receipts from these different investments should be treated.

SECTION 402. DISTRIBUTIONS FROM TRUSTS AND ESTATES. Subject to any contrary provision of the recipient trust's governing instrument, income includes an amount received as a distribution of income from a trust or an estate in which the trust has an interest other than a purchased interest, and principal includes an amount received as a distribution of principal from such a trust or estate. If a trustee purchases an interest in a trust that is an investment entity, or a decedent or donor transfers an interest in such a trust to a trustee, Section 401 applies to distributions from the trust.

Comment

Distributions from other trusts and estates. In determining whether a distribution from another trust is income or principal, it is first necessary to determine what the nature of the distribution is from the perspective of the distributing trust or estate and then to determine whether the governing instrument of the recipient trust contains any provision that would cause a distribution that the other trust treated as an income distribution to be a principal receipt.

Investment trusts. An investment entity to which the second sentence of this section applies includes a common trust fund, a business trust or any other entity organized as a trust for the purpose of receiving capital contributed by investors, investing that capital, and managing investment assets.

SECTION 403. BUSINESS AND OTHER ACTIVITIES CONDUCTED BY TRUSTEE.

(a) If a trustee who conducts a business or an activity described in subsection (c) determines that it is in the best interests of all the beneficiaries to account separately for the business or activity instead of accounting for it as part of the trust's general accounting records, the trustee may maintain separate accounting records for the activity's transactions whether or not the activity's assets are segregated from other trust assets.

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

(c) Activities for which the trustee may maintain separate accounting records include retail, manufacturing, service, and other traditional business activities, farming, raising and selling livestock and other animals, management of rental properties, extraction of minerals and other natural resources, timber operations, and activities to which Section 426 applies.

Comments

Purpose and scope. The provisions in Section 403 are intended to give greater flexibility to a trustee who operates a business or other activity in proprietorship form rather than in a wholly-owned corporation, and to facilitate the trustee's ability to decide the extent to which the net receipts from the activity should be apportioned to or between principal and income, just as the board of directors of a corporation owned entirely by the trust would decide the amount of the annual dividend to be paid to the trust. It permits a trustee to account for farming or livestock operations, rental properties, oil and gas properties, and timber operations as though they were held by a separate entity. It is not intended, however, to permit a trustee to account separately for a traditional securities portfolio to avoid the provisions of this Act that apply to such securities.

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

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

Separate accounts. Under Section 403, a trustee may or may not maintain separate bank accounts for business activities and all of the other receipts and disbursements. A professional trustee may decide not to maintain separate bank accounts, but an individual trustee, especially one who has continued a decedent's business practices, may continue the same banking arrangements that were used during the decedent's lifetime. In either case, the trustee is authorized to decide to what extent cash is to be retained as part of the business assets and to what extent it is to be transferred to the trust's general accounts, either as income or principal.

[Part] 2
Receipts Not Normally Apportioned

SECTION 410. PRINCIPAL RECEIPTS. Principal includes:

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

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

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

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

(5) except for receipts with a periodic due date to which Section 302(b) applies, money or property received that became due or accrued during an accounting period in which no current income beneficiary had an income interest; and

(6) other receipts as provided in [Part] 3 of [Article] 4.

Comment

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

SECTION 411. RENTAL PROPERTY. An amount received as rent of real or personal property, including an amount received for cancellation or renewal of a lease, is income. An amount received as a refundable deposit, including a security deposit or a deposit that is to be applied as rent for future periods, must be added to principal and held subject to the terms of the lease and is not available for distribution to a beneficiary until the trustee's contractual obligations have been satisfied with respect to that amount.

SECTION 412. OBLIGATIONS TO PAY MONEY.

(a) An amount received as interest on an obligation to pay money to the trustee, including an amount received as consideration for prepaying principal, is income, and no portion may be allocated to principal for amortization of premium. An amount received from the sale, redemption, or other disposition of such an obligation is principal.

(b) If an obligation's final maturity date will occur within one year after it is acquired by the trust, and if it does not provide for the payment of interest at least annually, any increase in value over its purchase price or its value when acquired by the trust is income in the accounting period it is received by the trustee. If its final maturity date will not occur within one year, any increase in value is principal when it is received.

(c) This section does not apply to obligations to which Sections 421 through 424, 426 and 427 apply.

Comment

Scope. Subsection (b) applies to all obligations issued at a discount, including U.S. Savings Bonds, zero-coupon bonds, and discount bonds that pay interest during only a part of the period before maturity; under subsection (b) the entire increase in value is principal when the trustee receives it. It also applies to inflation-indexed bonds; under subsection (b), any increase in principal due to inflation after issuance is principal upon redemption.

The Act eliminates the provision in the 1962 Act for the payment from principal of an amount equal to the increase in the value of U.S. Series E bonds because Section 103 authorizes the trustee to take into consideration the effect on the portfolio as whole of having a portion of the assets invested in bonds that do not pay interest currently and to make an adjustment from principal to income if appropriate.

SECTION 413. INSURANCE POLICIES AND OTHER CONTRACTS.

(a) Principal includes proceeds from a life insurance policy whose beneficiary is the trust or its trustee or a policy that insures the trust or its trustee against loss for the damage or destruction of, or loss of title to, a principal asset. Principal also includes dividends received from an insurance policy and the proceeds of any other contract in which the trust or its trustee is named as beneficiary. This section does not apply to a contract to which Section 421 applies.

(b) Insurance proceeds are income if they are from a policy that insures the trustee against the loss of occupancy or other use by an income beneficiary, the loss of income, or, subject to Section 403, the loss of profits from a business.

[Part] 3

Receipts Normally Apportioned

SECTION 420. INSUBSTANTIAL ALLOCATIONS NOT REQUIRED. If a trustee determines that an allocation required by Sections 421 through 426 is insubstantial, the trustee may make the allocation but is not required to do so. If the trustee decides not to allocate a receipt between principal and income because it is insubstantial, the receipt must be added to principal. An allocation is presumed to be insubstantial if:

(1) the amount of the allocation would increase or decrease an accounting period's net income, as determined before any adjustment, by less than 10 percent; or

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

Comment

This section is intended to relieve a trustee from making relatively small allocations while preserving the trustee's right to do so if, for example, an allocation is still large in terms of absolute dollars.

SECTION 421. DEFERRED COMPENSATION, ANNUITIES, AND SIMILAR PAYMENTS.

(a) This section applies to payments that a trustee may receive over a fixed number of years or during the life of one or more individuals because of services rendered or property transferred to the payor in exchange for future payments. The payments to which it applies include those made in cash or property from the payor's general assets or from a separate fund created by the payor, including a private or commercial annuity, an individual retirement account, and a pension, profit sharing, stock bonus, stock ownership plan, or similar arrangement. This section does not apply to payments to which Section 422 applies.

(b) To the extent that a payment is characterized as an interest or dividend payment or a payment made in lieu of interest or a dividend, it is income. The balance of the payment and any other payment received in the same accounting period that is not characterized as an interest, dividend, or equivalent payment, is principal.

(c) If no portion of any payment received in an accounting period from an annuity, account, plan, or similar arrangement, is income under subsection (b), the trustee shall allocate [10] percent of the payments for the period from the arrangement to income if the trustee expects all of the payments from the arrangement to be made over a fixed or predictable period of no more than five years after the date on which periodic payments to a trust or a successive income interest begin. The trustee shall allocate [20] percent of a payment to income if the trustee expects all of the payments to be made over a fixed or predictable period of more than five years after the date on which periodic payments to a trust or a successive income interest begin. In each case the balance is principal. A predictable period includes one that is based on an individual's life expectancy. In determining the number of years over which payments may be made, any power of the trustee to shorten the period by withdrawing additional amounts shall be ignored.

(d) If a trust receives the entire amount to which it is entitled within a single accounting period, the amount received is principal. If a trustee withdraws during an accounting period an amount larger than the amount required to be paid during that period, the amount received in excess of the amount required to be paid is principal.

(e) If the value of the fund from which the payments are made is greater at the end of the accounting period than the value at the beginning of the accounting period, a trustee may allocate up to 50% of the total payments received in the accounting period to income.

(f) If, to obtain an estate tax marital deduction for a trust, a trustee must allocate a larger portion of a payment to income than provided for by this section, the trustee shall increase the amount allocated to income to the extent necessary to obtain the marital deduction.

Comment

Scope. Section 421 applies to receipts from all forms of annuities and deferred compensation arrangements if the total amount is to be paid in installments over more than one year. It applies to bonuses that may be paid over only two or three years, deferred compensation arrangements, qualified and unqualified, that may last for much longer periods, and individual retirement accounts. It applies to plans to which the decedent or grantor has made contributions, just as it applies to individual annuity policies that she may have purchased entirely with her own funds, and it applies to variable annuities, insurance renewal commissions, annuities issued by commercial insurance companies and "private annuities" arising from the sale of property to another individual or entity in exchange for payments that are to be made for the life of one or more individuals. The section will apply whether the payments begin as soon as the trust becomes entitled to receive them or are deferred until a future date. It also applies to payments made either in cash or in kind (such as employer stock), although in most cases in-kind payments will probably be made in a single distribution that will be allocated to principal under subsection (d).

Other principal and income acts. Under the 1962 Act, deferred compensation payments are allocated to income each year in an amount "not in excess of" 5% of the deferred compensation's inventory value. Arguably, that means that the annual allocation can be anywhere from zero to 5% of the inventory value, but most trustees use 5%. The inventory value is usually the present value of all the future payments, determined as of the date on which the payments become subject to the trust. The Illinois Act allocates all periodic payments to principal if they are received "under an employment related contract or plan or an individual retirement account or annuity," but it includes a savings provision similar to that in subsection (e) to preserve the marital deduction. 760 ILCS 15/12.

Rationale for allocations. Section 421 produces an allocation to income that is roughly similar to the 1962 Act formula if the annual payments are the same throughout the payment period, and it should be simpler to administer. Under Section 421 the amount received by the income beneficiary is not dependent upon the interest rate that must be used for valuation purposes when the decedent dies, and if the payment to the trust increases or decreases from year to year because the fund from which the payment is made increases or decreases in value, the amount allocated to income will change accordingly.

The provisions in Section 421 apply to three broad types of plans. Subsection (b) applies to the first type, and subsection (c) applies to the other two. The first type consists of plans that provide for a current return on the deferred principal balance in the form of periodic interest or dividend payments or, in plans in which the value of the deferred payments is determined by reference to a number of "phantom" or actual shares of employer stock, periodic payments of amounts equivalent to the dividends that would be paid on those shares. The second type includes plans in which the amount to be paid is fixed, and each periodic payment reduces the remaining balance to be paid. Distributions from these plans are allocated according to the time period over which the installment payments will be made. The third type includes plans in which a separate fund is invested in assets whose value changes from time to time as the value of the underlying assets changes and as interest and dividends accumulate. In an arrangement of the third type the payments will not necessarily reduce the total value of the fund during the year. Under subsection 421(e), if the value of the fund is greater at the end of the accounting period than at the beginning, the trustee may allocate to income up to 50% of the payments received.

Section 421(c) presently provides that 10% of the annual amount received by the trust is allocated to income if all of the payments will be made within five years, and 20% if the payment period will be more than five years. This allocation arrangement was based on the payment pattern that would have resulted under the 1962 Act if the total amount payable under the plan was fixed. This approach was adopted because we had no information about how important the 1962 Act provisions were to trust officers and practitioners. It appears not to be very important because no one who has looked at the prior drafts has commented on it one way or the other. The two-tier arrangement (10% and 20%) is more complicated than I like, and **I would like to have the Drafting Committee's views** on whether we should simplify these provisions (and the similar provisions in Section 422 for liquidating assets) by providing for a 10%/income and 90%/principal allocation regardless of the time period over which payments will be made. The 10%/90% approach is used in Section 423 for oil and gas properties, and that, too, has not elicited any controversy, although one Commissioner would prefer to have all of the oil and gas payments allocated to principal. If a 10% allocation proves to be too little in a particular case, the trustee can use the power granted by Section 103 to distribute principal to the income beneficiary.

Marital deduction requirements. When an IRA is payable to a QTIP marital deduction trust, the IRS treats the IRA as separate terminable interest property, and requires that a QTIP election be made for it. In order to qualify for QTIP treatment, all of the IRA's income must be distributed annually to the QTIP marital deduction trust, and then must be allocated to trust income for distribution to the spouse. Rev. Rul. 89-89, 1989-2 C.B. 231. (These requirements can also be satisfied if the IRA beneficiary designation permits the spouse to require the trustee to withdraw the requisite amount from the IRA and distribute it to her, even though she never actually requires the trustee to do so; but we have to deal with the situation in which such a provision is not placed in the beneficiary designation.) In the case of older surviving spouses, whose life expectancy is less than 20 years, the amount of the annual required minimum distribution is large enough to carry out all of the IRA's income to the trust. (For example, if the spouse's expectancy is 16 years, the required distribution would be 1/16th of the IRA's value, or 6.25%, which is likely to be more than the current yield on the IRA assets.) If the spouse's expectancy is more than 20 years, however, the required minimum distribution may not be large enough to carry out all of the IRA income to the trust. In either case, however, an allocation under this Act of only 10% or 20% of the IRA distribution to trust income will not meet the requirement that all of the IRA's income be distributed from the trust to the spouse. Hence, the makeup provision in subsection (f) authorizing the trustee to make a larger allocation to income to the extent necessary to qualify for the marital deduction. In the case of a younger spouse with a longer life expectancy, the trustee may also have to withdraw an additional amount from the IRA to have enough cash available to distribute all of the IRA's income to the spouse.

Delayed payments. It is possible that a delay may occur before payments begin, which is why the time periods in subsection (c) are measured by reference to the date on which periodic payments actually begin. If the delay is prolonged and the beneficiary of the payments is a trust that qualifies for the marital deduction, Section 425(a) may apply.

SECTION 422. LIQUIDATING ASSETS.

(a) "Liquidating asset" means an asset whose value will diminish or terminate because the asset is expected to produce receipts for a period of limited duration. The term includes leaseholds, patents, trademarks, copyrights, royalty rights, and rights to receive payments during a period of more than one year under an arrangement that does not provide for the payment of interest on the unpaid balance. The term does not include deferred compensation that is subject to Section 421, natural resources that are subject to Section 423, timber that is subject to Section 424, activities that are subject to Section 426, or any asset for which the trustee establishes a reserve for depreciation under Section 503.

(b) The trustee shall allocate [20] percent of the receipts from a liquidating asset to income if, when the asset becomes subject to the trust or successive income interest, the trustee expects to receive payments from that asset for more than five years, or [10] percent if for five years or less, and shall allocate the balance to principal.

(c) If the trustee knows or can readily determine from information made available by an entity that a distribution from the entity is made in whole or in part from receipts produced by a liquidating asset owned by the entity, the trustee may allocate the distribution to or between principal and income under this section instead of Section 401 if the trustee determines that it produces a result fairer to the income beneficiary or the remainder beneficiary than the rules in Section 401.

Comment

Prior Acts. Section 11 of the 1962 Act allocates receipts from "property subject to depletion" to income in an amount "not in excess of 5%" of the asset's inventory value. The 1931 Act had a similar 5% rule that applied when the trustee was under a duty to change the form of the investment. The 5% rule imposes on a trust the obligation to pay a fixed annuity to the income beneficiary until the asset is exhausted. The balance of each year's receipts is added to principal where it is reinvested and produces additional income. The remainder beneficiary receives all of the receipts from unexpected growth in the asset (e.g., if royalties on a patent or copyright increase significantly). Conversely, if the receipts diminish more rapidly than expected, most of the amount received by the trust will go to income and little to principal. Moreover, if the annual payments remain the same for the life of the asset, the amount allocated to principal will usually be less than the original inventory value. Section 422 abandons the annuity approach.

Lottery payments. The reference in subsection (a) to "rights to receive payments" with no separately stated interest includes state lottery prizes and similar fixed amounts payable over time that are not deferred compensation arrangements covered by Section 421.

SECTION 423. MINERALS, WATER, AND OTHER NATURAL RESOURCES.

(a) An amount received because the trust owns an interest in minerals or other natural resources must be allocated as follows:

(1) If received as nominal delay rent or annual rent on a lease, it is income.

(2) If received from a production payment, it is income to the extent that the agreement creating the production payment

provides a factor for interest or its equivalent. The balance is principal.

(3) If received as a royalty, bonus, or delay rent that is more than nominal, 90 percent is principal and the balance is income.

(4) If received from a working interest or any other interest not provided for in paragraphs (1), (2) or (3), 90 percent of the net receipts is principal and the balance is income.

(b) An amount received because the trust owns an interest in water that is renewable is income. If the water is not renewable, 90 percent of the amount is principal and the balance is income.

(c) If a trust owns an interest in minerals, water, or other natural resources on the effective date of this [Act], the trustee may allocate receipts from the interest as provided in this section or in the manner used by the trustee before this [Act] takes effect. If the trust acquires an interest in minerals, water, or other natural resources after the effective date of this [Act], the trustee shall allocate receipts from the interest as provided in this section. If an interest in minerals, water, or other natural resources is transferred to the trust by a donor, this [Act] applies even if minerals, water, or other natural resources were not being extracted by the donor.

Comment

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

Section 423 allocates 90% of the net receipts to principal and 10% to income. A depletion provision that is tied to past or present

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

Effective date provision. Section 9(b) of the 1962 Act provides that the natural resources provision does not apply to property interests held by the trust on the effective date of the Act, which reflects concerns about the constitutionality of applying a retroactive administrative provision to interests in real estate, based on the opinion in the Oklahoma case of Franklin v. Margay Oil Corporation, 153 P2d 486, 501 (1944). Section 423(c) permits a trustee to use either the method provided for in this Act or the method used before the Act takes effect. Lawyers in jurisdictions other than Oklahoma may conclude that retroactivity is not a problem as to property situated in their states, and this provision permits trustees to decide, based on advice from counsel in states whose law may be different, whether they may apply this provision retroactively if they conclude that to do so is in the best interests of the beneficiaries. However, if the property is in a state other than the state where the trust is administered, the trustee must be aware that the law of the property's situs may control this question. The outcome turns on a variety of questions: whether the governing instrument specifies that the law of a state other than the situs of the property shall govern the administration of the trust, and whether the courts will follow the governing instrument provision; whether the trust's asset is the land itself or a leasehold interest in the land (as it frequently is with oil and gas property); whether a leasehold interest or its proceeds should be classified as real property or personal property, and if as personal property, whether applicable state law treats it as a movable or an immovable for conflict of laws purposes. See, Austin W. Scott and William F. Fratcher, 5A The Law of Trusts §§ 648, at 531, 533-534; 657, at 600 (4th ed. 1989)

SECTION 424. TIMBER.

(a) A trustee may account for net receipts from the sale of trees and related products under Section 403, subsection (b), or, if a trustee determines that the net receipts are insubstantial, may allocate the net receipts to principal. The presumptions in paragraphs (1) and (2) of Section 420 shall apply in determining whether net receipts are insubstantial. If a trust owns more than one block of timber property, a trustee may use different methods to account for net receipts from different blocks.

(b) If a trustee does not account under Section 403 for net receipts from the sale of trees and related products or allocate the net receipts to principal because they are insubstantial, the trustee shall allocate the net receipts:

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

(2) if the amount of timber removed from the land exceeds the block's rate of growth, to income to the extent of the tract's normal rate of growth, and the balance to principal.

(c) Net receipts from the lease of timberland or from a contract to cut trees from land owned by a trust must be allocated to income and principal by determining the amount of trees removed from the land under the lease or contract and applying the rules in paragraphs (1) and (2) of subsection (b). Net receipts from the sale of standing timber are principal.

(d) To the extent that advance payments, minimum royalties and bonuses are not allocated pursuant to subsection (a), they must be allocated to principal.

(e) In determining the net receipts from the sale of trees, a trustee shall deduct and transfer to principal an appropriate amount for depletion.

(f) This [Act] applies whether or not the decedent or transferor was harvesting trees from the property before it became subject to the trust.

<u>Comment</u>

Scope of section. The rules in Section 424 are intended to apply to all net receipts received from the sale of trees and any by-products from harvesting and processing trees without attempting to distinguish between the kind of trees that are cut or whether the trees are cut before or after a particular number of years of growth. The rules apply to the sale of trees that are expected to produce lumber for building purposes, trees sold as pulpwood, and Christmas and other ornamental trees.

The option to account for net receipts from timber separately under Section 403 takes into consideration the fact that timber harvesting operations may have been conducted before the timber property became subject to the trust, and that it makes sense to continue using accounting methods previously established for the property. But it also permits a trustee to use customary accounting practices for timber operations even if no harvesting occurred on the property before it became subject to the trust. Subsection (a) does not differentiate between net receipts received from cutting trees from property owned by the trustee and cutting trees from property leased by the trustee, but the expectation is that in the latter case the trustee is more likely to use a method of separate accounting under Section 403.

Under subsection (b), the amount of net receipts allocated to income depends upon whether the amount of timber removed is more or less than the rate of growth. The method of determining the "amount of timber" is up to the trustee, based on methods customarily used for the kind of timber involved. The fact that a certain amount of trees are removed during an accounting period does not necessarily mean that the same amount of trees was sold during the same period or, if the same amount was sold, that the trustee received the sales proceeds during that period. However, the ratio of timber removed to rate of growth in an accounting period can be applied to the net receipts for the same period to allocate those receipts between principal and income. If this proves to be unsatisfactory in a particular situation, separate accounting under Section 403 may be preferable.

The Act is not intended to prevent a tenant in possession of the property from using wood that he cuts on the property for firewood, mending fences, or making repairs to structures on the property.

SECTION 425. UNPRODUCTIVE PROPERTY.

(a) If a marital deduction is allowed for all or a part of a trust whose assets consist substantially of property that does not provide the surviving spouse with sufficient income from or use of the trust assets, considering the factors in Section 103(b), and if the amount the trustee distributes to the spouse from principal pursuant to the governing instrument and transfers from principal to income under Section 103 is insufficient to provide the spouse with the beneficial enjoyment required to obtain the marital deduction, the spouse may require the trustee to make the property productive or convert the property within a reasonable time or to exercise the power granted by Section 103, but the trustee, after considering the factors in Section 103(b), may decide which action or combination of actions to take.

(b) In all other cases, proceeds from the sale or other disposition of an asset shall be principal, and no portion of the proceeds shall be allocated to income. A trustee shall consider the extent to which an asset produced income or was used by the beneficiary only to determine whether an adjustment is appropriate under Section 103.

Comment

Duty to make property productive. In order to implement the effective use of the Uniform Prudent Investor Act, this Act abolishes the right to receive delayed income from the sales proceeds of an unproductive or underproductive asset, but it does not alter existing state law regarding the income beneficiary's right to compel the trustee to make property productive. As the law continues to develop in this area, the duty to make property productive in a particular situation should be determined by taking into consideration the performance of the portfolio as a whole and the extent to which a trustee has made principal distributions to the income beneficiary under the provisions of the governing instrument and Section 103 of this Act.

Subsection (a) adopts the substance of the provisions in Reg. §20.2056(b)-5(f)(4) and (5) to enable a trust for which a marital deduction is taken to obtain a marital deduction in states in which existing law is unclear about the surviving spouse's right to compel the trustee to make property productive. The trustee should also consider the application of Section 103 of this Act and the provisions of Rest. 3rd, Trusts (Prudent Investor Rule) § 240. Trusts for which the valuation of the right to receive income is important may also be affected by the Reg. § 1.7520-3(b)(2)(v) Example 1, § 20.7520-3(b)(2)(v) Examples 1 and 2, and § 25.7520-3(b)(2)(v) Examples 1 and 2, which provide that if the income beneficiary does not have the right to compel the trustee to make the property productive, the income interest is considered unproductive and may not be valued actuarially under those sections.

Uniform Prudent Investor Act. Section 2(b) of the Uniform Prudent Investor Act provides that "[a] trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole ..." The underproductive property provisions in Section 12 of the 1962 Act and Section 11 of the 1931 Act give the income beneficiary a right to receive a portion of the proceeds from the sale of underproductive property as "delayed income." In each Act the provision applies on an asset by asset basis rather than taking into consideration the trust portfolio as a whole.

Even in jurisdictions that have not adopted prudent investor legislation the unproductive property provisions of the principal and income acts have proven to be a significant problem for portfolio managers who seek to invest for total return. The provisions in the 1962 Act are difficult to interpret and apply to specific fact situations, and they do not permit trustees to take into account the extent to which a trustee may have distributed principal to the income beneficiary during a period of unproductivity to compensate for the lack of current return from the unproductive asset.

SECTION 426. DERIVATIVE FINANCIAL INSTRUMENTS AND OPTIONS.

(a) "Derivative financial instrument" means a contract that gives a trust the right or obligation to participate in some or all of the price changes of a commodity or other asset, or the changes in a rate, an index of prices, or other market indicator for an asset or a group of assets, and that either requires a settlement with a net cash payment or is customarily settled with a net cash payment.

(b) To the extent that a trustee does not account under Section 403 for transactions in derivative financial instruments, receipts from and disbursements made in connection with such transactions shall be allocated to principal.

(c) If a trustee grants an option to buy property from the trust, whether or not the trust owns the property when the option is granted, or an option that permits another person to sell property to the trust, or acquires an option to buy property for the trust or an option to sell an asset owned by the trust, and if the trustee or other owner of the asset must deliver the asset instead of settling with a net cash payment if the option is exercised, an amount received for granting such an option is principal, and an amount paid to acquire such an option must be paid from principal. A gain or loss realized upon the exercise of an option or upon a later sale of property acquired by the exercise of an option is principal.

(d) The trustee may determine under Section 103 the extent to which amounts added to principal under this section should be transferred to an income beneficiary.

Comment

Definition of "derivative." "Derivative" is a difficult term to define because new kinds of derivatives are invented daily as dealers tailor their terms to achieve specific financial objectives for particular clients. Since derivatives are contract-based, a derivative can probably be devised for almost any objective if another party can be found who is willing to assume the obligations required to meet those objectives.

The most comprehensive definition I have found is in the Exposure Draft of a Proposed Statement of Financial Accounting Standards titled "Accounting for Derivative and Similar Financial Instruments and for Hedging Activities," which was released by the Financial Accounting Standards Board (FASB) on June 20, 1996 (No. 162-B). The definition in subsection (a) is a derivative of the FASB definition that is contained in paragraph 6 and explained further in paragraphs 7 and 8 of the FASB Exposure Draft:

> 6. For purposes of this Statement, a derivative financial instrument is a financial instrument that, by its terms, at inception or upon occurrence of a specified event, provides the holder (or writer) with the right (or obligation) to participate in some or all of the price changes of an underlying (that is, one or more referenced financial instruments, commodities, or other assets, or other specific items to which a rate, an index of prices, or another market indicator is applied) and, except as noted below, does not require that the holder or writer own or deliver the underlying. A contract that requires ownership or delivery of the underlying is a derivative financial instrument if (a) the underlying is another derivative, (b) a mechanism exists in the market (such as an organized exchange) to enter into a closing contract with only a net cash settlement, or (c) the contract is customarily settled with only a net cash payment based on changes in the price of the underlying.
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>> 7. Insurance contracts and reinsurance contracts as defined and discussed in FASB Statements No. 60 ..., No. 97 ..., and No. 113 ..., except for financial guarantees written by insurance companies, are not derivative financial instruments for purposes of this Statement. A financial guarantee may or may not be a derivative financial instrument depending on whether it meets the definition in paragraph 6. For example, a financial guarantee is not a derivative financial instrument if the contract requires that, to collect, the guaranteed party must own the underlying at the time of default.
>>
>> 8. Most futures, forwards, swaps, and options are derivative financial instruments because their terms provide for net cash settlement, a mechanism exists in the market to enter into closing contracts with only a net cash settlement, or it is customary to settle those contracts with a net cash payment. Most loan commitments are not derivative financial instruments under this Statement because exercise of the commitment requires that the holder deliver an underlying promissory note to the lender in exchange for cash. A variable-rate debt instrument is not a derivative financial instrument under paragraph 6 because the underlying, which will be used to calculate the variable interest payments, is transferred between the parties.

A derivative is frequently described as including futures, forwards, swaps and options, terms that themselves require definition. FASB also considered using this approach in its definition, but abandoned it, explaining in paragraph 65 of the Exposure Draft:

> The definition of *derivative financial instrument* in this Statement includes those financial instruments generally considered to be derivatives, such as forwards, futures, swaps, options, and similar instruments. The Board considered defining a derivative financial instrument by merely referencing those commonly understood instruments, similar to paragraph 5 of Statement 119, which says that "...a derivative financial instrument is a futures, forward, swap, or option contract, or other financial instrument with similar characteristics." However, the continued development of financial markets and innovative financial instruments could ultimately render a

> definition based on examples inadequate and obsolete. The Board, therefore, decided to base the definition of a derivative financial instrument on a description of the common characteristics of those instruments in order to accommodate the accounting for newly developed derivatives. (Footnote omitted.)

Marking to market. A gain or loss that occurs because the trustee marks securities to market or to another value during an accounting period is not a transaction in a derivative financial instrument for purposes of the Act because it does not result in a cash receipt or disbursement by the trustee.

Entity-level activities. Section 426 does not apply to receipts from an entity that engages in activities to which this section applies. Distributions from the entity are income or principal under Section 402(c).

Options. Options to which subsection (c) applies include an option to purchase real estate owned by the trustee in an isolated real estate transaction, a put option purchased by a trustee to guard against a drop in value of a large block of marketable stock that must be liquidated to pay estate taxes, and a continuing and regular practice of selling call options on securities owned by the trust if delivery of the securities is required. It does not apply to an option if the consideration received or given for the option is not cash or property, including cross-options granted in a buy-sell agreement between owners of an entity.

SECTION 427. HYBRID ASSETS.

(a) This section applies to:

(1) assets from which a trust receives no distribution in an accounting period because the terms of the instrument provide that the issuer is not obligated to make a distribution before a date in a subsequent accounting period, or is obligated to make a distribution only upon the request of the trustee, and whose value is derived from the right it gives the owner to participate in the appreciation of and distributions from investment assets that provide the collateral for fulfillment of the issuer's obligations; and

(2) assets that give the owner the right to receive only the capital appreciation or only the current income return from other securities that provide the collateral for the fulfillment of the issuer's obligations.

(b) Distributions from an asset described in subsection (a)(1) shall be allocated to principal if the distribution is in exchange for the trust's entire interest in the asset, and shall be allocated to or between principal and income under Section 421 in the case of distributions made in the form of an annuity or installments that will result in the liquidation of the trust's interest in the asset over a period of years. Distributions from an asset described in subsection (a)(2) shall be allocated to principal if the asset gives the owner the right to receive only capital appreciation and shall be allocated between principal and income under Section 422 if the asset gives the owner the right to receive only the current return from the asset.

Comment

Assets whose value is based on other investment assets. Subsection (a)(1) is intended to describe deferred annuities and any other contractual arrangement that is collateralized with interests in mutual funds (frequently selected by the purchaser of the obligation), stocks, bonds and other traditional investment assets. It is not intended to cover directly-owned interests in mutual funds, personal holding companies, and the like, to which the entity distribution rules apply, but instead to indirect ownership of traditional investments through contractual arrangements that are frequently created to defer income taxation. Subsection (a)(2) is intended to describe assets designed to permit the owner to realize return exclusively in the capital appreciation of a security or exclusively in the interest or dividend return from a security, such as the "Primes" and "Scores" issued by Americus Trust, as well as other forms of stripped securities.

This is a very preliminary draft, offered for discussion purposes. The descriptions in subsection (a) need additional work.

[Article] 5

ALLOCATION OF DISBURSEMENTS DURING ADMINISTRATION OF TRUST

SECTION 501. DISBURSEMENTS FROM INCOME.

(a) A trustee shall make the following disbursements from income to the extent that they are not disbursements to which Section 202(2)(iii) applies:

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

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

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

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

Comment

The regular compensation of a trustee or the trustee's agent would include compensation based on a percentage of either principal or income or both. In the New York statute, one-third of trustee fees and investment advisory fees are charged to income and the balance to principal.

SECTION 502. DISBURSEMENTS FROM PRINCIPAL.

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

(1) the remaining one-half of the disbursements described in Sections 501(a)(1) and (2);

(2) all of the trustee's compensation computed on principal as an acceptance, distribution, or termination fee, and disbursements made to prepare property for sale;

(3) principal payments of a trust debt;

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

(5) insurance premiums paid on a policy not described in Section 501(4) of which the trust is the owner and beneficiary;

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

(7) costs related to environmental matters, including the cost of assessing environmental conditions, remedying and removing environmental contamination, monitoring remedial activities and the release of substances, preventing future releases of substances, collecting amounts from persons liable or potentially liable for the costs of these activities, penalties imposed under environmental laws or regulations and other payments made to comply with such laws or regulations, amounts payable to third parties based on statutory or common law claims, and costs of defending claims based on environmental matters.

(b) If the trust owns a policy on the life of an individual but is not the beneficiary of the policy, insurance premiums paid on the policy are a distribution from principal to the policy beneficiary.

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

Comment

Environmental expenses. This draft reflects a shift in emphasis, which has been heavily influenced by the annotation at 43 A.L.R.4th 1012 (Duty as Between Life Tenant and Remainderman with Respect to Cost of Improvements or Repairs Made Under Compulsion of Governmental Authority). All environmental expenses are now payable from principal in the first instance, subject to the power of the trustee to transfer funds from income to principal under Section 504. The provision formerly in Section 501, allocating some of these expenses to income, has been deleted. This treatment is consistent with the premise underlying the approach with respect to receipts - that when a receipt is not clearly a current return on a principal asset, it should be added to principal because over time both the income beneficiary and the remainder beneficiaries benefit from this treatment. Here, allocating to principal the payments required by environmental laws imposes in the same way the detriment of those payments on both income and remainder beneficiaries. The Drafting Committee may want to consider broadening this provision to cover other expenditures made under compulsion of governmental authority.

At the suggestion of members of the ACTEC Environmental Law Committee, I have lifted the first five lines of subsection (a)(7) from the description of "environmental remediation" that is in Reg.§ 301.7701-4(e), which contains the definition of an "environmental remediation trust." This does not imply that this Act would apply to an environmental remediation trust, but rather that it is a useful and thoroughly vested description of the kinds of expenses we want to include in this section of the Act. Expenses incurred to comply with environmental laws include the cost of environmental consultants, administrative proceedings and burdens of every kind imposed as the result of an administrative or judicial proceeding, even though the burden is not formally characterized as a penalty.

Title proceedings. Expenses described in Section 502(a)(4) are intended to include the "action to assure title" that is mentioned in Section 13(c)(2) of the 1962 Act.

Insurance premiums. The insurance premiums referred to in section 502(a)(5) are premiums on life insurance policies owned by the trust, which represent the trust's periodic investment in the insurance policy. There is no comparable provision in the 1962 Act.

Taxes. Generation-skipping transfer taxes and the tax imposed by Internal Revenue Code Section 4980A(d) (15% excise tax on excess retirement accumulations, which increases the estate tax) are payable from principal under subsection (a)(6).

Interest on estate taxes. Section 13(c)(5) of the 1962 charges interest on estate and inheritance taxes to principal. The 1931 Act has no provision. This draft provides in section 501(a)(3) that all interest must be paid from income, without distinguishing between interest on death taxes and interest on other kinds of obligations. The justification for paying interest on obligations like unpaid taxes from income is that income-producing assets do not have to be liquidated to pay the debt, and the interest expense should be matched against the income earned from those assets. This may or may not be true when the payment of estate and inheritance taxes is deferred. Deferral may occur because there are insufficient income-producing assets to pay the taxes, and in this case the notion of matching interest expense against investment income has no validity. However, it may also occur because payment of the federal estate taxes has been deferred under Section 6166 of the Code, which can happen even if there are liquid, income-producing assets in the estate because eligibility for deferral under that section is based in part on whether the value of the closely-held business on which the taxes are being deferred is more than 35% of the gross estate and not on the lack of liquid assets to pay taxes.

In recent years there have been a number of cases involving the question of whether administration expenses and interest on estate and inheritance taxes can be paid from income and deducted for income tax purposes without reducing the amount of a marital deduction or charitable contributions deduction. The IRS position is that administration expenses must reduce the amount of a marital or charitable transfer even if they are properly paid from income under authority of the governing instrument and state law, and this issue is currently before the United States Supreme Court in Commissioner of Internal Revenue v. Estate of Otis C. Hubert (No. 95-1402). However, the IRS has agreed that interest on estate and inheritance taxes may be deducted for income tax purposes without having to reduce the estate tax deduction for amounts passing to a charity or surviving spouse, whether the interest is paid from principal or income. Rev. Rul. 93-48, 93-2 C.B. 270. But not all estates want to deduct interest on deferred taxes on the income tax return because deducting that interest for estate tax purposes may produce more beneficial results, especially if the estate is in the 55% estate tax bracket.

With this as background, the question for the Drafting Committee is, should the Act follow the 1962 Act and require interest to be paid from principal? An alternative is to authorize the fiduciary to decide whether to charge interest and administration expenses to principal. For example, the Georgia statute provides:

> Expenses incurred in connection with the settlement of a decedent's estate, including interest and penalties concerning taxes, fees of attorneys and personal representatives, and court costs, may be charged against the principal or income at the discretion of the personal representative. OCGA § 53-12-219(e).

Expenses of investing and reinvesting. Section 13(c) of the 1962 Act charges to principal "the cost of investing and reinvesting principal" to the extent such a cost is not provided for in section 13(a). Section 13(a)(1) charges to income "ordinary expenses incurred in connection with the administration, management or preservation of the trust property ..." and Section 13(a)(5) charges to income "all expenses reasonably incurred for current management of principal and application of income." The items described in Sections 13(a)(1) and (5) have been included in Section 501(a)(3) as income expenses. It has been suggested that we also include a reference to the "cost of investing and reinvesting principal," but it is difficult to identify an expense fitting that general description that isn't also described in Section 501(a)(3) as an ordinary expense incurred in connection with the administration or preservation of trust property. Does the Drafting Committee want to add any other language?

SECTION 503. TRANSFERS FROM INCOME TO PRINCIPAL FOR DEPRECIATION.

(a) "Depreciation" means a reduction in value of a fixed asset having a useful life of more than one year due to wear, tear, decay, corrosion, or gradual obsolescence.

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

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

(2) during the administration of a decedent's estate; or

(3) of property held by the trustee when this [Act] takes effect for which the trustee is not then making an allowance for depreciation.

(c) A trustee shall determine depreciation by the straight-line method based on its value when it is acquired by the trustee, estimated useful life, and estimated salvage value. After adopting a useful life, the trustee may change the useful life and estimated salvage value for a later accounting period. In selecting an asset's useful life, the trustee shall consider the extent to which the asset's life is likely to be prolonged by repairs, maintenance, and similar disbursements that may be made from income.

(d) A method of depreciation more rapid than the straight-line method may be used in some or all accounting periods if the trustee determines that the straight-line method does not accurately reflect the rate at which an asset is likely to deteriorate or become obsolete, but it may not be used solely because an asset’s market value declines.

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

Comment

Prior Acts. The 1931 Act had no provision for depreciation. Section 13(a)(2) of the 1962 Act provides that "[t]he following charges shall be made against income: ... a reasonable allowance for depreciation on property subject to depreciation under generally accepted accounting principles..." That provision has been resisted by many trustees. Some do not provide for any depreciation on various grounds including the argument that it is not needed to protect the remainder beneficiaries if the land is appreciating, and the argument that generally accepted accounting principles may not require depreciation to be taken if the property is not part of a business.

The Drafting Committee concluded that depreciation should be discretionary. For those trustees who elect to provide for depreciation, additional provisions in this draft describe how it may be determined. The reference to generally accepted accounting principles has been deleted intentionally to emphasize the fact that, for purposes of this Act, any provision that involves a transfer of funds from income to principal is subject to the trustee's duty of impartiality and the rules in Section 102 rather than rules based on commercial accounting concepts.

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

Section 503(b)(3) carries forward a provision in the 1962 Act that prohibits the retroactive application of the depreciation provision. It applies only to property held by a trustee on the effective date of this Act if the trustee was not then making an allowance for depreciation. This would apply both in states whose prior law did not provide for depreciation and in 1962 Act states where trustees were not making allowances for depreciation even though the Act does provide for it.

SECTION 504. TRANSFERS FROM INCOME TO REIMBURSE PRINCIPAL.

(a) If a trustee makes or expects to make a principal disbursement described in this subsection, for which it has not been or is not expected to be reimbursed by a third party, the trustee may transfer an appropriate amount from income to principal, in one or more accounting periods, to reimburse principal for a disbursement made or to provide a reserve for future disbursements. Principal disbursements to which this subsection applies include:

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

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

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

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

(5) costs described in Section 502(a)(7) other than penalties and costs of defending against the imposition of penalties.

(b) A trustee may continue to transfer amounts from income to principal as provided in subsection (a) after an income interest ends if the property becomes subject to a successive income interest.

Comment

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

SECTION 505. INCOME TAXES.

(a) A tax required to be paid by a trustee because of receipts allocated to income must be paid from income.

(b) A tax required to be paid by a trustee because of receipts allocated to principal must be paid from principal even though the tax is called an income tax by the taxing authority.

(c) A tax required to be paid by a trustee because of taxable income from an entity in which the trust or estate owns an interest must be paid from principal to the extent that the entity does not make a distribution that is income to the trust in or before the accounting period in which the trustee pays the tax.

Comment

Electing Small Business Trusts. Section 1302 of the Small Business Job Protection Act of 1966 (P.L. 104-188) introduced the concept of the Electing Small Business Trust (ESBT), which is a trust that owns stock in one or more S corporation but would not have qualified, prior to the 1996 Act, as a stockholder in an S corporation. The portion of an ESBT that consists of the S corporation stock is treated as a separate trust for tax purposes (but not for trust accounting purposes), and the S corporation income is taxed directly to that portion of the trust without any deduction for distributions to beneficiaries from that portion of the trust. The tax paid by the "separate trust" would initially be allocated to or between principal and income under Section 505(c), but it seems clear that there will probably be situations in which there will be inequities because of the need to pay tax in one accounting period from principal, followed by corporate distributions (that are income under this Act) in a later accounting period that perhaps should bear the burden of the earlier tax payment. It is too early to anticipate how ESBTs will work in practice, but the equitable adjustments powers in Section 506 are probably sufficient to enable a trustee to correct inequities of this kind.

SECTION 506. EQUITABLE ADJUSTMENTS BETWEEN PRINCIPAL AND INCOME BECAUSE OF TAXES.

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

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

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

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

(b) If the amount of an estate tax marital deduction or charitable contributions deduction is reduced because a fiduciary deducts an amount that is paid from principal for income tax purposes instead of deducting it for estate tax purposes, and as a result estate taxes paid from principal are increased and income taxes paid by an estate, trust, or beneficiary are decreased, each estate, trust, or beneficiary that benefits from the decrease in income tax shall reimburse the principal from which the increase in estate tax is paid. The total reimbursement shall equal the increase in the estate tax to the extent that the principal used to pay the increase would have qualified for a marital deduction or charitable contributions deduction but for the payment. The pro rata share of the reimbursement for each estate, trust, or beneficiary whose income taxes are reduced shall be the same percentage of the total reimbursement as the percentage that its decrease in income tax is of the total decrease in income tax. An estate or trust shall reimburse principal from income.

Comment

Discretionary adjustments. Subsection (a) permits the fiduciary to make adjustments between income and principal because of tax law provisions. Adjustments would be permitted under this section in several situations: If a fiduciary elects to deduct administration expenses that are paid from principal on an income tax return instead of on the estate tax return; or if a distribution of principal assets to a trust or other beneficiary causes the taxable income of an estate or trust to be carried out to the distributee and causes the persons who actually receive the income to be relieved of any obligation to pay income tax on the income; or if a trustee realizes a capital gain on the sale of a principal asset and pays a large state income tax on the gain but is not permitted under applicable federal income tax rules to deduct the state tax from the capital gain in computing trust's capital gain tax, and the income beneficiary receives the benefit of the deduction.

This section also applies to a qualified Subchapter S trust (QSST) whose income beneficiary is required to include a pro rata share of the S corporation's taxable income in his return. If the QSST does not receive a cash distribution from the corporation that is large enough to cover the income beneficiary's tax liability, the trustee may distribute additional cash from principal to the income beneficiary. In this case the retention of cash by the corporation benefits the trust principal. This situation could occur if the corporation's taxable income includes capital gain from the sale of a business asset and the sales proceeds are reinvested in the business instead of being distributed to shareholders.

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

Irrevocable grantor trusts. Under sections 671-679 of the Internal Revenue Code, a person who creates an irrevocable trust for the benefit of another person may be subject to tax on the trust's income or capital gains, or both, even though the grantor is not entitled to receive any income or principal from the trust. Because this is now a well-known tax result, many trusts have been created to produce this result, but there are also trusts that are unintentionally subject to this rule. The Act does not authorize a trustee to distribute funds from the trust to the grantor in these cases because it is difficult to establish a rule that applies to trusts where this tax result is unintended but does not apply where it is intended. Grantors who intend this result rarely state it as an objective in the governing instrument, but instead rely on the operation of the tax law to produce the desired result. As a result it is not easy to determine from the governing instrument if the result was intentional or unintentional. If the drafter of such a trust wants the trustee to have the authority to distribute principal or income to the grantor to reimburse the grantor for taxes paid on the trust's income or capital gains, such a provision should be placed in the governing instrument. In some situations the IRS may require that such a provision be placed in a governing instrument as a condition to issuing a private letter ruling.

[Article 6]
MISCELLANEOUS PROVISIONS

SECTION 601. UNIFORMITY OF INTERPRETATION.

This [Act] shall be applied and construed to effectuate its general purpose to make uniform the law with respect to the subject matter of this [Act] among states enacting it.

SECTION 602. SHORT TITLE.

This [Act] may be cited as the Revised Uniform Principal and Income Act (199__).

SECTION 603. SEVERABILITY.

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

SECTION 604. REPEAL.

The following acts and parts of acts are repealed:

(1)
(2)
(3)

SECTION 605. EFFECTIVE DATE.

This [Act] takes effect on ....

SECTION 606. APPLICATION OF [ACT] TO EXISTING TRUSTS AND ESTATES. Except as expressly provided in the governing instrument or in this [Act], this [Act] applies to any trust or decedent’s estate after this [Act] takes effect.