D R A F T

FOR APPROVAL

REVISION OF UNIFORM PRINCIPAL AND INCOME ACT

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REVISION OF UNIFORM PRINCIPAL AND INCOME ACT

WITH PREFATORY NOTE AND COMMENTS

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REVISION OF UNIFORM PRINCIPAL AND INCOME ACT

PREFATORY NOTE

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

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

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

Revision of the 1931 and 1962 Acts

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

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

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

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

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

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

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

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

(2) The allocation between principal and income of receipts from derivatives, options, and asset-backed securities.

(3) Disbursements made because of environmental laws.

(4) Income tax obligations resulting from the ownership of S corporation stock and interests in partnerships.

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

(6) The power to make adjustments between principal and income to correct inequities caused by tax elections or peculiarities in the way the fiduciary income tax rules apply.

(7) The allocation of net income from harvesting and selling timber between principal and income, a question for which there are no specific rules in the prior Acts.

(8) A de minimis rule that permits the trustee to avoid making small adjustments that would otherwise be required by the rigid application of the apportionment rules.

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

(1) Charging depreciation against income is no longer mandatory, and is left to the discretion of the trustee.

(2) Income from partnerships will be based on actual distributions from the partnership, in the same manner as corporate distributions.

(3) Distributions from corporations and partnerships that exceed 20% of the entity's gross assets will be principal whether or not intended by the entity to be a partial liquidation.

(4) An income beneficiary's estate will be entitled to receive only net income actually received by a trust before the beneficiary's death and not items of accrued income.

(5) An "unincorporated entity" concept has been introduced to deal with businesses operated by a trustee, including farming and livestock operations, and investment activities in rental real estate, natural resources, timber, and derivatives.

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

(7) The 1962 Act rule for "property subject to depletion" (patents, copyrights, royalties, deferred compensation and the like), which provides that a trustee may allocate up to 5% of the asset's inventory value to income and the balance to principal, has been replaced by a rule that allocates 90% of the amounts received to principal and the balance to income.

(8) The unproductive property rule has been eliminated for trusts other than marital deduction trusts.

Coordination with the Uniform Prudent Investor Act

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

As to modern investing see, e.g., the Preface to, terms of and Comments to the Uniform Prudent Investor Act (1994); the discussion and reporter's note by Edward C. Halbach, Jr. in Restatement (Third) of Trusts: Prudent Investor Rule (1992); Bevis Longstreth, Modern Investment Management and the Prudent Man Rule (1986); John H. Langbein & Richard A. Posner, The Revolution in Trust Investment Law, 62 A.B.A.J. 887 (1976); and Jeffrey N. Gordon, The Puzzling Persistence of the Constrained Prudent Man Rule, 62 N.Y.U.L. Rev. 52 (1987). See also R.A. Brearly, An Introduction to Risk and Return from Common Stocks (2d ed. 1983); Jonathan R. Macey, An Introduction to Modern Financial Theory (1991). As to the need for principal and income reform see, e.g., 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); 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) and Kenneth L. Hirsch, Inflation and the Law of Trusts, 18 Real Prop., Prob., & Tr.J. 601 (1983). See also, Jerold I. Horn, The Prudent Investor Rule – Impact on Drafting and Administration of Trusts, 20 ACTEC Notes 26 (Summer 1994).

REVISION OF UNIFORM PRINCIPAL AND INCOME ACT

[ARTICLE] 1
DEFINITIONS AND FIDUCIARY DUTIES

SECTION 101. SHORT TITLE. This [Act] may be cited as the Uniform Principal and Income Act (1997).

SECTION 102. DEFINITIONS. In this [Act]:

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

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

(4) "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.

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

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

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

(8) “Net income” means the total receipts allocated to income during an accounting period minus the disbursements made from income during the period. In this definition, receipts and disbursements include items transferred to or from income during the period under this [Act].

(9) “Person” means an individual, corporation, business trust, estate, trust, partnership, limited liability company, association, joint venture, or any other legal or commercial entity. The term does not include a government or governmental subdivision, agency, or instrumentality.

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

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

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

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

Comment

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

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).

"Net income." Items transferred to or from income under this Act include transfers made under Sections 104(a), 424(c), 502(c), 503(b), 504(a), and 506.

"Terms of a trust." This term replaces "governing instrument," which was used in earlier drafts of the Act, to make it clear that the Act applies to oral trusts as well as those whose terms are expressed in written documents. The definition is based on the Restatement (Second) of Trusts § 4 (1959) and the Restatement (Third) of Trusts § 4 (Tent. Draft No. 1, 1996). Constructional preferences or rules would also apply, if necessary, to determine the terms of the trust.

SECTION 103. FIDUCIARY DUTIES; GENERAL PRINCIPLES.

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

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

(2) may administer a trust or estate by the exercise of a discretionary power of administration given the fiduciary by the terms of the trust or the will even if the fiduciary exercises that power in a manner different from a provision of this [Act];

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

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

(b) In exercising the power to adjust granted by Section 104(a) or a discretionary power of administration regarding a matter within the scope of this

[Act], whether granted by the terms of a trust, a will, or this [Act], a fiduciary shall administer a trust or estate impartially, based on what is fair and reasonable to all of the beneficiaries, unless the terms of the trust or the will clearly manifest an intention that the fiduciary shall 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. The rule in Section 2(a) of the 1962 Act is restated in Section 103(a), without changing its substance, to emphasize that the Act contains only default rules and that provisions in the terms of the trust are paramount. However, Section 2(a) applies only to the allocation of receipts and disbursements to or between principal and income. In this Act, the first sentence of Section 103(a) makes it clear that it also applies to any matter that is within the scope of Articles 2 and 3. Section 103(a)(2) incorporates the rule in Section 2(b) of the 1962 Act that a discretionary allocation made by the trustee that is contrary to a rule in the Act should not give rise to an inference of imprudence or partiality by the trustee.

The Act deletes the language that appears 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 "prudent man" rule of the 1962 Act.

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 id.* § 233 cmt. p.

Questions for which there is no provision. Section 103(a)(4) allocates receipts and disbursements to principal when there is no provision for a different allocation in the terms of the trust, the will, or the Act. This may occur because money is received from a financial instrument not available at the present time (inflation-indexed bonds might have fallen into this category had they been announced in 1998) or because a transaction is of a type or occurs in a manner not anticipated by the Drafting Committee or the drafter of the instrument.

Allocating to principal a disbursement for which there is no provision in the Act or the terms of the trust preserves the income beneficiary's level of income in the year it is allocated to principal, but thereafter less income will be produced by the principal. Allocating to principal a receipt for which there is no provision will increase the income received by the income beneficiary in subsequent years, and will eventually, upon termination of the trust, also favor the remainder beneficiary. Allocating these items to principal implements the rule that requires a trustee to administer the trust impartially, based on what is fair and reasonable to both income and remainder beneficiaries. If, however, the trustee decides that an adjustment between principal and income is needed to achieve an impartial result, the trustee may make an appropriate adjustment under Section 104(a).

Duty of impartiality. The terms of a trust may 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. Section 103(b) provides that in such cases the rule of impartiality applies if the terms of the trust do 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(b) is intended to be a statement of public policy that would apply even if the terms of a trust provide that this Act specifically or principal and income legislation generally does not apply, but fail to provide a rule to deal with a matter provided for in this Act.

SECTION 104. TRUSTEE'S POWER TO ADJUST.

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

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

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

(2) the intent of the settlor;

(3) the identity and circumstances of the beneficiaries;

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

(5) the assets held in the trust; the extent to which they consist of financial assets, interests in closely held enterprises, tangible and intangible personal property, or real property; the extent to which an asset is used by a beneficiary; and whether an asset was purchased by the trustee or received from the settlor;

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

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

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

(9) the anticipated tax consequences of an adjustment.

(c) A trustee may not make an adjustment:

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

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

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

(4) from any amount that is permanently set aside for charitable purposes under a will or the terms of a trust;

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

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

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

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

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

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

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

Comment

Purpose and Scope of Provision. The purpose of Section 104 is to enable a trustee to select investments based on the standards of a prudent investor without having to realize a particular portion of the portfolio's total return in the form of traditional trust accounting income such as interest and dividends. Section 104 provides a power to adjust total return between principal and income if three conditions are met: (1) the trustee must be managing the trust assets under the prudent investor rule; (2) the terms of the trust must express the income beneficiary's rights in terms of the right to receive "income" in the sense of traditional trust accounting income; and (3) the trustee must determine that he is unable to comply with the duty to administer the trust impartially by applying the terms of the trust and the provisions in other sections of this Act.

The second condition will apply when the terms of the trust require all of the income to be distributed at regular intervals; or when the terms of the trust authorize a trustee to distribute all of the income, but permit the trustee to decide the amount to be distributed to each member of a class of beneficiaries; or when the terms of a trust provide that the beneficiary shall receive the greater of the trust accounting income or a fixed dollar amount or a fractional share of the value of the trust assets. Even if the trust authorizes the trustee in its discretion to distribute income to the beneficiary or to accumulate some or all of the income, Section 104 may apply if the trustee decides to distribute income to the beneficiary because the trust accounting income represents the maximum amount that the trustee may distribute.

A trustee who decides that, to achieve the suitable risk and return objectives for the trust, the portfolio should be composed of financial assets whose total return will result primarily from capital appreciation rather than dividends and interest can decide when the trust acquires those assets whether and to what extent an adjustment from principal to income may be necessary under this section. On the other hand, a trustee who decides that the risk and return objectives for the trust are best achieved by a portfolio whose total return includes interest and dividend income that is sufficient to provide the income beneficiary with the beneficial interest to which the beneficiary is entitled under the terms of the trust may decide that it is unnecessary to exercise the power of adjustment.

This section does not empower a trustee to change the degree of beneficial enjoyment to which a beneficiary is entitled under the terms of the trust; rather, it authorizes the trustee to make adjustments that may be necessary to see that the beneficiary receives the required beneficial enjoyment unaffected by the investment decisions made by a trustee operating under the prudent investor rule. The paramount consideration in applying Section 104(a) is the requirement in Section 103(b) that the trustee must act "impartially based on what is fair and reasonable to all of the beneficiaries unless the terms of the trust clearly manifest an intention that the fiduciary must or may favor one or more beneficiaries." The power to adjust is subject to control by the court to prevent an abuse of discretion. Restatement (Second) of Trusts § 187 (1959). *See also id.* §§ 183, 232, 233 cmt. p (1959).

Section 104 will be important for trusts that are irrevocable when a State adopts the prudent investor rule by statute or judicial approval of the rule in Restatement (Third) of Trusts: Prudent Investor Rule (1992). Wills and trust instruments executed after the rule is adopted can be drafted to reflect the client's thoughts about the effect of investment decisions on distributions to beneficiaries.

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. 31 Real Property, Probate & Trust Journal 1 (1996). See also Joel C. Dobris, Why Trustee Investors Often Prefer Dividends to Capital Gain and Debt Investments to Equity – A Daunting Principal and Income Problem. 32 Real Prop. Prob. & Tr. J. ___ (1997)

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

> **Example (1)** – T is the trustee of a trust that provides income to A for life, remainder to B. T received from the settlor a portfolio of financial assets invested 20% in stocks and 80% in bonds. In response to the Uniform Prudent Investor Act, T determines that the suitable risk and return objectives for this portfolio indicate that it should be invested 50% in stocks and 50% in bonds. As a result, the dividend and interest income is decreased. T is authorized, after considering the factors in subsection (b), to adjust between principal and income to the extent T considers it necessary to increase the amount paid to the income beneficiary.
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> **Example (2)** – T is the trustee of a trust that requires the income to be paid to the settlor's son C for his life, remainder to C's daughter D. In a period of very high inflation, T purchases bonds that pay double digit interest and determines that a portion of the interest, which is allocated to income under the other provisions of this Act, is a return of capital. In consideration of the loss of value of principal due to inflation and other factors that T considers relevant, T may transfer a portion of the interest to principal.
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> **Example (3)** – T is the trustee of a trust that requires the income to be paid to the settlor's sister E for life, remainder to charity F. E is a retired schoolteacher who is single and has no children. The terms of the trust permit T to invade principal to provide for E's health and to support her in her accustomed manner of living, but do not otherwise indicate that T should favor E or F. E's income from her social security, retirement pension, and savings is more than the amount required to provide for her accustomed standard of living. Applying prudent investor standards, T determines that the trust assets should be invested entirely in growth stocks that produce virtually no dividend income. Even though it is not necessary to invade principal to maintain E's accustomed standard of living, she is entitled to receive from the trust the degree of beneficial enjoyment normally accorded a person who is the sole income beneficiary of a trust, and T is authorized to adjust from principal to income to provide her with that degree of enjoyment.
>
> **Example (4)** – T is the trustee of a trust whose situs is State X. The trust became irrevocable before State X adopted the prudent investor rule. The terms of the trust require all of the income to be paid to G for life, remainder to H. The trust agreement gives T the power to invade principal for the benefit of G

for "dire emergencies only," and limits the amount that can be distributed from principal over the lifetime of the trust to an aggregate amount that does not exceed 6% of the trust's value at its inception. The trust's portfolio is invested 50% in stocks and 50% in bonds. After State X adopts the prudent investor rule, T determines that, to achieve the suitable risk and return objectives for the trust, the assets should be invested 90% in stocks and 10% in bonds, which increases the total return from the portfolio and decreases the dividend and interest income. In a year in which G does not experience a dire emergency T may nevertheless exercise the power to adjust in Section 104(a) to the extent that T determines that the adjustment is exclusively from the portion of capital appreciation resulting from the change in the portfolio's asset allocation. If T is unable to determine the extent to which capital appreciation resulted from the change in asset allocation or is unable to maintain adequate records to determine the extent to which principal distributions to G for dire emergencies do not exceed the 6% limitation, T may not exercise the power to adjust. See Joel C. Dobris, Limits on the Doctrine of Equitable Adjustment in Sophisticated Postmortem Tax Planning, 66 Iowa L. Rev. 273 (1981).

Example (5) – T is the trustee of a trust that is the sole beneficiary of the settlor's IRA. The IRA holds a diversified portfolio of marketable financial assets. The trust receives annual distributions from the IRA that comply with the minimum distribution requirements of the Internal Revenue Code, and T allocates 10% of the amount received each year to income under Section 421 of this Act. The total return on the IRA's assets exceeds the amount required to be paid to the trust, and as a result the value of the IRA's assets at the end of the year exceeds the value at the beginning of the year. The appreciation in value of the IRA is a relevant factor that T may consider under Section 104(b)(6) in determining whether to exercise the power of adjustment and the extent to which an adjustment should be made to administer the trust impartially, assuming the terms of the trust do not require T to favor one or more of the beneficiaries. T may also consider, under Section 104(b)(9), the anticipated tax consequences of the adjustment, if the distribution will cause the beneficiary to be subject to income tax on the additional amount distributed, in determining the amount of the adjustment. In years in which the required distributions reduce the value of the IRA, the decrease in value is a relevant factor for T to consider under Section 104(b)(6) in determining whether and to what extent to exercise the power of adjustment.

Factors to consider in exercising the power to adjust. The factors in subsection (b) are derived in part from the list of circumstances set forth in Section 2(c) of the Uniform Prudent Investor Act that a trustee is required to consider in investing and managing trust assets, with modifications to adapt them to the purposes of this Act.

A trustee may retain assets received from the settlor that are not readily marketable financial assets, such as an interest in a closely-held enterprise, real estate, and tangible personal property, or assets that will be liquidated over time such as rights to receive payments from an individual retirement account and other assets to which Sections 421 through 427 may apply. While Section 3 of the Uniform Prudent Investor Act requires a trustee to diversify the investments of a trust, that rule does not apply if "the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying." The special circumstances may include the wish to retain a family business, the benefit derived from deferring liquidation of the asset in order to defer payment of income taxes, or the anticipated capital appreciation from retaining an asset such as undeveloped real estate for a long period. To the extent the trustee retains assets received from the settlor because of special circumstances that overcome the duty to diversify, Section 104(b)(5) permits the trustee to take these circumstances into account in determining whether and to what extent the power to adjust should be exercised to change the results produced by other provisions of this Act that apply to the retained assets.

Limitations on the power to adjust. The purpose of subsection (c)(1) through (4) is to preserve tax benefits that may be one of the settlor's purposes for creating the trust. Subsection (c)(5), (6), and (8) deny the power to adjust to a trustee who has a beneficial interest in the trust in order to prevent adverse tax consequences to the trustee, and subsection (7) denies the power to adjust to any beneficiary, whether or not possession of the power may have adverse tax consequences to the beneficiary.

Under subsection (c)(1), a trustee cannot make an adjustment that diminishes the income interest in a trust for which an estate tax or gift tax marital deduction is allowed; but this subsection does not prevent the trustee from making an adjustment that increases the amount of income paid from a marital deduction trust to the surviving spouse. Subsection (c)(1) will apply to any trust that qualifies for the marital deduction because the surviving spouse has a general power of appointment over the trust; in the case of a qualified terminable interest property (QTIP) trust, it applies only if, and to the extent that, the fiduciary makes the election required to obtain the tax deduction; and it will not apply to a so-called "estate" trust, in which the income is not required to be paid at least annually to the surviving spouse, and may be accumulated for a term of years or for the life of the surviving spouse, but which qualifies for the marital deduction if the principal and undistributed income is paid to the surviving spouse's estate when she dies. Reg. § 20.2056(c)-2(b)(1)(iii).

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

If subsection (c)(5), (6), (7), or (8), prevents a trustee from exercising the power to adjust, subsection (d) permits cotrustees to exercise the power unless the terms of the trust clearly do not permit them to do so.

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

Trust terms that limit a power to adjust. Subsection (f) deals with trust provisions that limit a trustee's power to make an adjustment. Ultimately, the effect of any provision in a document is a question of interpretation. Ordinarily, a clause in an instrument executed before the adoption of this Act should not be construed as forbidding the use of the power of adjustment because the power is intended to enable trustees acting under such instruments to employ effectively the prudent investor rule. Instruments executed after the adoption of this Act should have a specific reference to this power of adjustment in order to forbid its use. 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

DECEDENT'S ESTATE OR TERMINATING INCOME INTEREST

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 a 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 which apply to trustees and the rules in paragraph (5). 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 which apply to trustees and by:

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

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

(C) paying from principal all other 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, disposition of remains, family allowances, and death taxes and related penalties that are apportioned to the estate or terminating income interest by the will, the terms of the trust, or applicable law.

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

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

(5) A fiduciary may not reduce principal or income receipts from property described in paragraph (1) because of a payment described in Section 501 or 502 to the extent that the will, the terms of the trust, 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 estate or terminating income interest may become obligated to pay after the property is distributed.

Comment

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 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. Paragraphs (3) and (4) of this section treat an outright pecuniary bequest different from a pecuniary bequest in trust, which is the same treatment provided for in Section 5(b)(2) of the 1962 Act.

Interest on pecuniary bequests. Section 201(3) provides that the beneficiary of an outright pecuniary amount is to receive the interest or other amount provided by applicable law if there is no provision in the will or the terms of the trust. Many States have no applicable law that provides for interest to be paid on an outright pecuniary gift under an inter vivos trust; this section provides that in such a case the interest to be paid shall be the same as on testamentary pecuniary gifts. This provision is intended to accord gifts under inter vivos instruments the same treatment as testamentary gifts. 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. 1997).

Administration expenses. The United States Supreme Court has considered the question of whether administration expenses can be paid from income produced by property passing in trust for a surviving trust and for charity and deducted for income tax purposes without reducing the amount of a marital deduction or charitable deduction. The Court rejected the IRS position that administration expenses paid from income must reduce the amount of a marital or charitable transfer even if they are properly paid from income under the terms of the trust and state law, and held that the value of the transferred property is not reduced unless the administration expenses are material in light of the income the trust corpus could have been expected to generate. *Commissioner of Internal Revenue v. Estate of Otis C. Hubert*, No. 95-1402, 1997 U.S. LEXIS 1920, at *26-*27 (Mar.18, 1997). The provision in Section 201(2)(B) follows the approach of the Supreme Court.

An additional advantage in giving the fiduciary the discretion to pay administration expenses from principal or income is that, if the fiduciary's decision is based upon whether those expenses will be deducted for estate tax purposes or income tax purposes, it eliminates the need to adjust between principal and income that occurs when, for example, an expense that is paid from principal is deducted for income tax purposes or an expense that is paid from income is deducted for estate tax purposes.

Interest on estate taxes. The IRS agrees 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. Not all fiduciaries will 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 has little or no income or the income tax bracket is significantly lower than the estate tax bracket. Section 13(c)(5) of the 1962 Act charges interest on estate and inheritance taxes to principal. The 1931 Act has no provision. Section 501(3) provides that, except to the extent provided in Section 201(2)(B) or (C), all interest must be paid from income.

SECTION 202. DISTRIBUTION TO RESIDUARY AND REMAINDER BENEFICIARIES.

(a) Each beneficiary described in Section 201(4) is entitled to receive a portion of the net income equal to the beneficiary's fractional interest in undistributed principal assets, using values as of the distribution date. If a fiduciary makes more than one distribution of assets to beneficiaries to whom this section applies, each beneficiary, including one who does not receive part of the distribution, is 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.

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

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

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

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

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

(c) The rules in this section 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 or gain to each person as of a distribution date, the fiduciary shall maintain appropriate records showing the interest of each beneficiary in that net income or gain.

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 several commentators. *See*, *e.g.*, Richard B. Covey, Marital Deduction and Credit Shelter Dispositions and the Use of Formula Provisions 80 (1984 & Supp. 1997); Thomas H. Cantrill, Fractional or Percentage Residuary Bequests: Allocation of Postmortem Income, Gain and Unrealized Appreciation, 10 Probate Notes 322, 327 (1985).

[ARTICLE] 3

APPORTIONMENT AT BEGINNING AND END OF INCOME INTEREST

SECTION 301. WHEN RIGHT TO INCOME BEGINS AND ENDS.

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

(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 a testator's death 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; or

(3) 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.

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

(d) An income interest ends on the day before an income beneficiary dies or another terminating event occurs. For purposes of this [Act], an income interest also ends on the last day of a period during which there is no beneficiary to whom a trustee may distribute income.

Comment

Period during which there is no beneficiary. The purpose of the second sentence in subsection (d) is to provide that, at the end of a period during which the trustee is directed to accumulate income because there is no discretionary or mandatory income beneficiary, the trustee must apply the same apportionment rules that apply when a mandatory income interest ends. This would occur, for example, in a trust that is created for the settlor's grandchildren before any grandchildren have been born.

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

(a) An income receipt or disbursement other than one to which Section 201(1) applies must be allocated to principal if its due date occurs before a decedent dies in the case of an estate or before an income interest begins in the case of a trust or successive income interest.

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

(c) 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]. Distributions to shareholders or other owners from an entity to which Section 401 applies are deemed to be due on the date fixed by the entity for determining who is entitled to receive the distribution or, if no date is fixed, on the declaration date for the distribution. A due date is periodic for receipts or disbursements that must be paid at regular intervals under a lease or an obligation to pay interest or if an entity customarily makes distributions at regular intervals.

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 also provides that an asset passing to an inter vivos trust by a bequest in the settlor's will is governed by the rule that applies to a testamentary trust, so that different rules apply to assets passing to an inter vivos trust depending upon whether they were transferred to the trust during the settlor's life or by his will.

Having several different rules that apply to similar transactions 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 by a testamentary bequest.

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 the interest portion of a mortgage payment, 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, the pre-death portion of the first periodic payment due after death is apportioned to principal in the case of a testamentary trust or securities bequeathed by will to an inter vivos 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 it accrues before a person dies or an income interest begins unless the obligation is specifically given to a devisee or remainder beneficiary, in which case all of the accrued interest passes under Section 201(1) to the person who receives the obligation. The same rule applies if the obligation has a due date, but it is not periodic.

SECTION 303. APPORTIONMENT WHEN INCOME INTEREST ENDS.

(a) In this section, "undistributed income" 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 or net income that has been added or is required to be added to principal pursuant to the terms of the trust.

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

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

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, with respect to undistributed income, most settlors would 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 to avoid causing disputes about whether the trustee should have distributed collected cash before the income beneficiary died.

Under the prior Acts, an income beneficiary or his estate is entitled to receive a portion of any payments, other than dividends, that are due or that have accrued when the income interest terminates. The last sentence of subsection (a) changes that rule by providing that such items are not included in undistributed income. The items affected include periodic payments of interest, rent, and dividends, as well as items that accrue over a longer period of time. The rules in this section and in Section 302 work in the following manner: If an income interest ends on July 30, a periodic payment of rent that is due on July 20 but unpaid when the successive income interest begins on July 31 would be added to principal of the successive income interest when received, and the entire periodic payment of rent that is due on August 20 would be income when received by the successive income interest. Neither the income beneficiary of the terminated income interest nor the beneficiary's estate would be entitled to any part of the July 20 or the August 20 payments, and none of the August 20 payment would be apportioned to principal of the successive income interest.

Beneficiary with an unqualified power to revoke. The requirement in subsection (b) to pay undistributed income to a mandatory income beneficiary or her estate does not apply if the beneficiary has an unqualified power to revoke more than five percent of the trust immediately before the income interest ends. Without this exception, subsection (b) would apply to a revocable living trust whose settlor is the mandatory income beneficiary during her lifetime, even if her will provides that all of the assets in the probate estate are to be distributed to the trust.

If a trust permits the beneficiary to withdraw all or a part 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, a trustee is not required to pay her or her estate the undistributed income attributable to the portion of the principal that she left in the trust, 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 be distributed under the terms of the trust. If the beneficiary has the power to withdraw 25% of the trust principal, the trustee must pay to her or her estate the undistributed income from the 75% that she cannot withdraw.

[ARTICLE] 4

ALLOCATION OF RECEIPTS DURING ADMINISTRATION OF TRUST

[PART] 1

RECEIPTS FROM ENTITIES

SECTION 401. CHARACTER OF RECEIPTS.

(a) In this section, “entity” means a corporation, partnership, joint venture, limited liability company, regulated investment company, real estate investment trust, common trust fund, and any other organization in which a trustee has an interest other than a trust or estate to which Section 402 applies or a business or activity to which Section 403 applies.

(b) Except as otherwise provided in this section, cash received by a trustee from an entity must be allocated to income.

(c) Receipts from an entity which must be allocated to principal include:

(1) property other than cash, except as otherwise provided in paragraph (4);

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

(3) cash or property received in total or partial liquidation of the entity; and

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

(d) Cash or property is received in partial liquidation:

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

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

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

(f) 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 entity's board of directors or other person or group of persons authorized to exercise powers to pay money or transfer property comparable to those of a corporation's board of directors.

Comment

Entities to which Section 401 applies. The reference to partnerships in Section 401(a) is intended to include all forms of partnerships, including limited partnerships, limited liability partnerships, and variants that have slightly different names and characteristics from State to State. The section does not apply, however, to receipts from an interest in property that a trust owns as a tenant in common with one or more co-owners.

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 cash received because of a net short-term capital gain is 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 104 is necessary as a result.

Distribution 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 (d)(1), any distribution designated by the entity as a partial liquidating distribution is principal regardless of the percentage of total assets that it represents, but if a distribution exceeds 20% of the entity's gross assets the entire distribution is a partial liquidation even though the entity doesn't describe it as such or describes the distribution as an ordinary dividend.

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

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 because it sold 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. In such a case the trustee may have the power under Section 104(a) to make an adjustment between income and principal to take these factors into account, although Section 104(c) may prevent an adjustment in the case of a marital deduction trust.

SECTION 402. DISTRIBUTION FROM TRUST OR ESTATE. Subject to the terms of a recipient trust, 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 must be allocated to income. An amount received as a distribution of principal from such a trust or estate must be allocated to principal. 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 a receipt 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 terms of the recipient trust contains any provision that would, for example, 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 other activity determines that it is in the best interest 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 its transactions, whether or not its 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 are 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 amount received as principal in the trust's general accounting records to the extent the trustee determines that the amount received is no longer required in the conduct of the business.

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

(1) retail, manufacturing, service, and other traditional business activities;

(2) farming;

(3) raising and selling livestock and other animals;

(4) management of rental properties;

(5) extraction of minerals and other natural resources;

(6) timber operations; and

(7) activities to which Section 426 applies.

Comment

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 (or, where permitted by state law, a single-member limited liability company), 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. The following must be allocated to principal:

(1) to the extent not allocated to income under this [Act], assets received from a:

(A) transferor during the transferor's lifetime;

(B) decedent's estate;

(C) trust with a terminating income interest; or

(D) payor pursuant to a contract naming the trust or its trustee as beneficiary;

(2) cash or other property received from the sale, exchange, liquidation, or change in form of a principal asset, including realized profit, subject to 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) net income received in a period during which there is no beneficiary to whom a trustee may or must distribute income; and

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

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, must be allocated to 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.

Comment

Receipts that are capital in nature. To the extent that receipts under a lease are denominated as "rent" for purposes of invoking contractual or statutory remedies for nonpayment, but are actually reimbursements of principal expenditures for improvements to the leased property, a trustee may consider making an adjustment to reimburse principal by the amount that has been added to the monthly rent.

SECTION 412. OBLIGATION TO PAY MONEY.

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

(b) An amount received from the sale, redemption, or other disposition of an obligation to pay money to the trustee more than one year after it is purchased or acquired by the trustee, including an obligation whose purchase price or value when it is acquired is less than its value at maturity, must be allocated to principal. If the obligation matures within one year after it is purchased or acquired by the trustee, an amount received in excess of its purchase price or its value when acquired by the trust must be allocated to income.

(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 short-term obligations such as U.S. Treasury Bills, and long-term obligations such as U.S. Savings Bonds, zero-coupon bonds, and discount bonds that pay interest during part, but not all, of the period before maturity. Under subsection (b) the entire increase in value of these obligations is principal when the trustee receives it unless the obligation, when acquired, has a maturity of less than one year. In order to have one rule that applies to all discount obligations, 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. The provision for bonds that mature within one year after acquisition by the trustee is derived from the Illinois Act. 760 ILCS 15/8 (1996).

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

Effect of Section 104. Section 104 authorizes the trustee to consider 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 necessary.

Variable or floating interest rates. The reference in subsection (a) to variable or floating interest rate obligations is intended to clarify that, even though an obligation's interest rate may change from time to time based upon changes in an index or other market indicator. An obligation to pay money containing a variable or floating rate provision is subject to this section and is not to be treated as a derivative financial instrument under Section 426.

SECTION 413. INSURANCE POLICIES AND SIMILAR CONTRACTS.

(a) 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 must be allocated to principal. Dividends received from an insurance policy and the proceeds of any other contract in which the trust or its trustee is named as beneficiary must also be allocated to principal. This section does not apply to a contract to which Section 421 applies.

(b) Insurance proceeds must be allocated to 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 between principal and income required by Sections 421 through 424 or Section 427 is insubstantial, the trustee may allocate the entire receipt to principal if one of the circumstances described in Section 104(c) does not apply to such an allocation. This power may be exercised by a cotrustee in the circumstances described in Section 104(d), and it may be released for the reasons and in the manner described in Section 104(e). 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 the allocation, 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 value of the trust's assets 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 an allocation is large in terms of absolute dollars. For example, if a trust's assets have a value of $1,000,000 and annual net income of $40,000, and if the assets include a working interest in an oil well that produces net receipts of $400 a year, the trustee may allocate all of the net receipts to principal instead of allocating 10%, or $40, to income under Section 423. If, however, the net receipts from the working interest are $35,000 a year, the trustee may decide that this is a sufficiently significant amount to the income beneficiary that the allocation of $3,500 provided for by Section 423 should be made. This section would also relieve a trustee from having to allocate net receipts from the sale of trees in a small woodlot between principal and income.

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

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 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, or stock ownership plan. This section does not apply to payments to which Section 422 applies.

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

(c) If no part of a payment is characterized as interest, a dividend, or an equivalent payment, and all or part of the payment is required to be made, a trustee shall allocate to income [10] percent of the part that is required to be made during the accounting period and the balance to principal. If no part of a payment is required to be made or the payment received is the entire amount to which the trustee is entitled, the entire payment must be allocated to principal.

(d) If, to obtain an estate tax marital deduction for a trust, a trustee must allocate more of a payment to income than provided for by this section, the trustee shall allocate to income the additional amount necessary to obtain the marital deduction.

Comment

Scope. Section 421 applies to receipts from all forms of annuities and deferred compensation arrangements, whether the total amount will be received in a lump sum or in installments over several years. It applies to bonuses that may be received 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 settlor has made contributions, just as it applies to an annuity policy that she may have purchased individually. It also applies to variable annuities, deferred 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-kind payments usually will be made in a single distribution that will be allocated to principal under the second sentence of subsection (c).

The 1962 Act. 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. While that language suggests that the annual allocation may range from zero to 5% of the inventory value, in practice the rule is usually treated as prescribing a 5% allocation. 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, which makes the amount of the annual income allocation dependent on the interest rate that happens to apply on the decedent's date of death even if it is significantly higher or lower than the average long-term rate.

Other principal and income acts. 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 (d) to preserve the marital deduction. 760 ILCS 15/12 (1996).

The Missouri Act provides that, "if the principal consists of . . . rights to receive payments from a benefit plan, including, without limitations, any pension, retirement, individual retirement, death benefit, stock bonus or profit sharing plan, or system of trust, and rights to receive payments on a contract for deferred compensation, in no event shall the trust be deemed to have received income with respect to such property until the trust receives a distribution with respect to such property, and, in any event, only ten percent of the receipts from such property on a noncumulative basis is income, and the balance is principal." Mo. Rev. Stat. § 456.800 (1996).

The California Act provides that payments received on a contract for deferred compensation ". . . shall be allocated entirely to income or apportioned between income and principal as the trustee in its discretion may determine, but in no event shall the amount allocated to principal exceed a reasonable allowance for depletion or amortization." Cal. Prob. Code § 16310 (West 1996).

Rationale for allocation. 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 is much simpler to administer. The amount allocated to income under Section 421 is not dependent upon the interest rate that is used for valuation purposes when the decedent dies, and if the payments received by the trust increase or decrease from year to year because the fund from which the payment is made increases or decreases in value, the amount allocated to income will also increase or decrease.

Application of Section 104. A trustee operating under Section 3 of the Uniform Prudent Investor Act may retain certain assets and avoid the requirement to diversify if there are special circumstances such as a desire to defer the liquidation of an asset in order to defer payment of income taxes. Section 104 of this Act gives a trustee who is acting under the prudent investor rule the power to adjust from principal to income if, considering the portfolio as a whole and not just receipts from deferred compensation, an adjustment is necessary under that section.

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, an IRS ruling states that 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. If an allocation to income under this Act of 10% of the required distribution from the IRA will not meet the requirement that all of the IRA's income be distributed from the trust to the spouse, the provision in subsection (d) requires the trustee to make a larger allocation to income to the extent necessary to qualify for the marital deduction.

The marital deduction requirements can also be satisfied if the IRA beneficiary designation permits the spouse to require the trustee to withdraw the necessary amount from the IRA and distribute it to her, even though she never actually requires the trustee to do so. If such a provision is in the beneficiary designation, a distribution under subsection (d) would not be necessary.

SECTION 422. LIQUIDATING ASSET.

(a) In this section, "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, an activity that is subject to Section 426, or any asset for which the trustee establishes a reserve for depreciation under Section 503.

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

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. Under each of those Acts, the balance of each year's receipts is added to principal. A fixed payment may produce unfair results. 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 be allocated 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. For these reasons, Section 422 abandons the annuity approach under the 5% rule.

Lottery payments. The reference in subsection (a) to rights to receive payments under an arrangement that does not provide for the payment of 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) Receipts from an interest in minerals or other natural resources must be allocated as follows:

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

(2) If received from a production payment, a receipt must be allocated to income to the extent that the agreement creating the production payment

provides a factor for interest or its equivalent. The balance must be allocated to principal.

(3) If an amount received as a royalty, bonus, or delay rental is more than nominal, 90 percent must be allocated to principal and the balance to income.

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

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

(c) This [Act] applies without regard to whether a decedent or donor was extracting minerals, water, or other natural resources before the interest became subject to the trust.

(d) 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 [the effective date of this [Act]]. 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.

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(d) 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 from that of Oklahoma, whether they may apply this provision retroactively if they conclude that to do so is in the best interests of the beneficiaries.

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 terms of the trust specify 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 terms of the trust; 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 timber and related products under subsection (b) or Section 403 or, if the trustee determines that net receipts are insubstantial, may allocate the net receipts to principal. The presumptions in Section 420 apply in determining whether net receipts are insubstantial. If a trust owns more than one block of timber land, the 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 timber 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;

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

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

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

(c) In determining the net receipts from the sale of timber, a trustee shall deduct and transfer to principal a reasonable amount for depletion.

(d) This [Act] applies regardless of whether a decedent or transferor was harvesting timber from the property before it became subject to the trust.

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

Comment

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. Subsection (a) applies to net receipts from property owned by the trustee and property leased by the trustee.

Section 424 refers to a "block" of timberland instead of a "tract" because "block" is a concept used in the income tax regulations for the purpose of aggregating timber and land for purposes of valuation and accounting under Reg. § 1.611-3(d). The assumption is that a trustee who owns a large amount of timber will have organized its accounting records based on a block concept for income tax purposes; using "block" in this Act is intended make it clear that a different approach is not required for trust accounting purposes.

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.

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 removed and the rate of growth is up to the trustee, based on methods customarily used for the kind of timber involved.

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. PROPERTY NOT PRODUCTIVE OF INCOME.

(a) If a marital deduction is allowed for all or 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, and if the amounts that the trustee transfers from principal to income under Section 104 and distributes to the spouse from principal pursuant to the terms of the trust are insufficient to provide the spouse with the beneficial enjoyment required to obtain the marital deduction, the spouse may require the trustee to make property productive of income, convert property within a reasonable time, or exercise the power conferred by Section 104(a). The trustee 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 are principal without regard to the amount of income the asset produces during any accounting period.

Comment

Prior Acts' Conflict with 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 by taking into consideration the trust portfolio as a whole, and this creates a significant problem for portfolio managers who seek to invest for total return. In determining the amount of delayed income, the provisions in the 1962 Act do not permit trustees to take into account the extent to which a trustee may have distributed principal to the income beneficiary to compensate for insufficient income from the unproductive asset. In this Act, distributions of principal to the income beneficiary are a factor that a trustee must consider under Section 104(b)(7) in deciding whether and to what extent to exercise the power to adjust conferred by Section 104(a).

Duty to make property productive of income. In order to implement the Uniform Prudent Investor Act, this Act abolishes the right to receive delayed income from the sales proceeds of an asset that produces no income or insufficient income, but it does not alter existing state law regarding the income beneficiary's right to compel the trustee to make property productive of income. As the law continues to develop in this area, the duty to make property productive of current income 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 terms of the trust and has made adjustments under Section 104 of this Act.

Trusts for which the valuation of the right to receive income is important may be affected by 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.

Marital deduction trusts. 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 of income. The trustee should also consider the application of Section 104 of this Act and the provisions of Rest. 3rd, Trusts (Prudent Investor Rule) § 240, at 186, app. § 240, at 252 (1992).

Once the two conditions have occurred – insufficient beneficial enjoyment from the property and the spouse's demand that the trustee take action under this section – the trustee must act; but instead of the formulaic approach of the 1962 Act, which is triggered only if the trustee sells the property, this Act permits the trustee to decide whether to make the property productive of income, convert it, transfer funds from principal to income, or to take some combination of those actions. The trustee may rely on the power conferred by Section 104(a) to adjust from principal to income if the trustee decides that it is not feasible or appropriate to make the property productive of income or to convert the property. Given the purpose of this section, the power under Section 104(a) would be exercised only to transfer principal to income, and not to transfer income to principal.

Section 425 would not apply to so-called "estate" trusts, in which the income may be accumulated for a term of years or for the life of the surviving spouse, but which qualify for the marital deduction if the principal and undistributed income is paid to the surviving spouse's estate when she dies. Reg. § 20.2056(c)-2(b)(1)(iii).

SECTION 426. DERIVATIVES AND OPTIONS.

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

(b) To the extent that a trustee does not account under Section 403 for transactions in derivatives, receipts from and disbursements made in connection with those transactions must 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, grants 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 the trustee or other owner of the asset is required to deliver the asset if the option is exercised, an amount received for granting the option must be allocated to principal, and an amount paid to acquire the option must be paid from principal. A gain or loss realized upon the exercise of an option, including an option granted to a settlor of the trust for services rendered, must be allocated to principal.

Comment

Scope and application. It is difficult to predict how many trustees will invest directly in derivative financial instruments rather than participating indirectly through investment entities that may utilize these instruments in varying degrees. If the investment is indirect through entities, any distribution from the entity will be governed by the rules in Section 401. For those trustees who do invest in derivatives to a significant extent, the expectation is that many of them will account for them under Section 403 as a separate activity; if they choose not to, Section 426(b) provides the default rule. Certain types of option transactions in which trustees may engage are dealt with separately in subsection (c) to distinguish those transactions from ones involving options that are embedded in derivative financial instruments.

Definition of "derivative." "Derivative" is a difficult term to define because new derivatives are invented daily as dealers tailor their terms to achieve specific financial objectives for particular clients. Since derivatives are typically 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 of derivative 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 Section 426(a) is based in part upon the FASB definition and in part upon very helpful comments by Professor William D. Harrington of St. John's University Law School.

The purpose of the definition in subsection (a) is to implement the substantive rule in subsection (b) that provides for all receipts and disbursements to be allocated to principal to the extent the trustee elects not to account for transactions in derivatives under Section 403. As a result, it is much shorter than the FASB definition, which serves much more ambitious objectives.

A derivative is frequently described as including futures, forwards, swaps and options, terms that themselves require definition, and this definition avoids these terms. FASB used the same approach, 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 if it does not result in a cash receipt or disbursement by the trustee.

Receipt of property other than cash. If a trustee receives property other than cash upon the settlement of a derivatives transaction, that property would be principal under Section 410(2).

Entity-level activities. Many trusts are apt to participate in derivatives transactions indirectly by owning interests in entities that engage in such transactions. Section 426 does not apply to receipts from an entity that engages in derivatives transactions. Distributions from the entity are income or principal under Section 401.

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 if the consideration received or given for the option is something other than cash or property, such as cross-options granted in a buy-sell agreement between owners of an entity.

SECTION 427. ASSET-BACKED SECURITIES.

(a) In this section, "asset-backed security" means an asset whose value is based upon the right it gives the owner to receive distributions from the proceeds of financial assets that provide collateral for the security. The term includes an asset that gives the owner the right to receive only the interest or other current return from the collateral financial assets or only the proceeds from the capital investment in the collateral financial assets. It does not include an asset to which Section 401 or 421 apply.

(b) If a trust receives a payment from the interest or other current return and the capital investment of the collateral financial assets, the trustee shall allocate to income the portion of a payment that the payor identifies as being from the interest or other current return, and shall allocate the balance of the payment to principal.

(c) If a trust receives one or more payments in exchange for the trust's entire interest in an asset-backed security in one accounting period, the trustee shall allocate the payments to principal. If a payment is one of a series of payments that will result in the liquidation of the trust's interest in the security over more than one accounting period, the trustee shall allocate [10] percent of the payment to income and the balance to principal.

Comment

Scope of section. An asset-backed security includes an "interest only" or a "principal only" security that permits the owner to receive only the interest payments received from the bonds, mortgages or other assets that are the collateral for the asset-backed security, or only the principal payments made on those collateral assets. An asset-backed security also includes securities that permit the owner to participate either the capital appreciation of a security or in the interest or dividend return from a security, such as the "Primes" and "Scores" issued by Americus Trust.

[ARTICLE] 5

ALLOCATION OF DISBURSEMENTS DURING ADMINISTRATION OF TRUST

SECTION 501. DISBURSEMENTS FROM INCOME. A trustee shall make the following disbursements from income to the extent that they are not disbursements to which Section 201(2)(B) or (C) 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) recurring premiums on insurance covering the loss of a principal asset or the loss of income from or use of the asset.

Comment

Trustee fees. The regular compensation of a trustee or the trustee's agent includes 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.

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

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 Section 501(1) and (2);

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

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

(4) expenses of a proceeding that concerns primarily principal, including a proceeding to construe 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) disbursements related to environmental matters, including reclamation, 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 those activities, penalties imposed under environmental laws or regulations and other payments made to comply with those laws or regulations, statutory or common law claims by third parties, and defending claims based on environmental matters.

(b) If a trust owns a policy of insurance on the life of an individual and the trust is not the beneficiary of the policy, 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. All environmental expenses are payable from principal in the first instance, subject to the power of the trustee to transfer funds to principal from income under Section 504. However, the Drafting Committee decided that it was not necessary to broaden this provision to cover other expenditures made under compulsion of governmental authority. In general, see 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).

The environmental expenses paid by a trust are to be paid from principal under Section 502(a)(7) on the assumption that they will generally be extraordinary in nature. Environmental expenses might be paid from income if the trustee is carrying on a business that uses or sells toxic substances, in which case environmental clean up costs would be a normal cost of doing business. In accounting for such costs under Section 403, such costs will be a factor in determining how much of the net receipts of the business is trust income. Paying all other environmental expenses from principal is consistent with this Act's approach regarding 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 and remainder beneficiaries benefit from this treatment. Here, allocating payments required by environmental laws to principal imposes the detriment of those payments over time on both the income and remainder beneficiaries.

The first part of subsection (a)(7) is based upon the definition of an "environmental remediation trust" in Reg. § 301.7701-4(e). This is not because the Act applies to an environmental remediation trust, but rather that the definition is a useful and thoroughly vetted description of the kinds of expenses that a trustee owning contaminated property might incur. 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 to protect a trust's property (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. Insurance premiums referred to in Section 502(a)(5) include title insurance premiums. They also include 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).

SECTION 503. TRANSFERS FROM INCOME TO PRINCIPAL FOR DEPRECIATION.

(a) In this section, "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) under this section if the trustee is accounting under Section 403 for the business or activity in which the asset is used.

(c) 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 a charge shall be made against income for ". . . 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. One reason given is that a charge for depreciation is not needed to protect the remainder beneficiaries if the land is appreciating; another is 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. A transfer of funds from income to principal under this section is subject to the trustee's duty of impartiality and the rule in Section 103(b).

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(b)(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 504. TRANSFERS FROM INCOME TO REIMBURSE PRINCIPAL.

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

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

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

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

Comment

Prior Acts. The sources of Section 504 are 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, which authorizes a trustee to establish an allowance for depreciation out of income if principal is used for extraordinary repairs, capital improvements and special assessments; and Section 12(3) of the 1931 Act, which 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, and includes in subsection (b)(4)the express 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.

SECTION 505. INCOME TAXES.

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

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

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

(1) from income to the extent that receipts from the entity are allocated to income; and

(2) from principal to the extent that:

(A) receipts from the entity are allocated to principal; and

(B) the trust's share of the entity's taxable income exceeds the total receipts in paragraphs (1) and (2)(A).

(d) For purposes of this section, receipts allocated to principal or income shall be reduced by the amount distributed to a beneficiary from principal or income for which the trust receives a deduction in calculating the tax.

Comment

Electing Small Business Trusts. An Electing Small Business Trust (ESBT) is a creature created by Congress in the Small Business Job Protection Act of 1996 (P.L. 104-188). For years after 1996, an ESBT may qualify as an S corporation stockholder even if the trustee does not distribute all of the trust's income annually to its beneficiaries. 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 even if some or all of that income is distributed to the beneficiaries.

A trust normally receives a deduction for distributions it makes to its beneficiaries. Subsection (d) takes into account the fact that an ESBT may have to pay tax on trust accounting income that is distributed to the beneficiaries. Additional guidance has not been issued by the Internal Revenue Service, and it is too early to anticipate technical questions that may arise, but if technical problems create inequities, the power in Sections 506 and 104 to make adjustments is probably sufficient to enable a trustee to correct them.

Equitable adjustments. If the trustee distributes principal to an income beneficiary and receives an income tax deduction for the distribution, an equitable adjustment under Section 506 may be appropriate. In addition, if the provisions in Section 505 do not produce a result that is fair to both income and remainder beneficiaries, this is a factor that the trustee may consider in deciding whether and to what extent an adjustment may be necessary under Section 104(a).

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

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

(1) elections and decisions, other than those described in subsection (b), that the fiduciary makes 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 must 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 proportionate share of the reimbursement for each estate, trust, or beneficiary whose income taxes are reduced must be the same as its proportionate share 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. Section 506(a) would permit discretionary adjustments in situations like these: (1) A fiduciary elects to deduct administration expenses that are paid from principal on an income tax return instead of on the estate tax return; (2) 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 (3) 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 income tax payment from the capital gain in calculating the trust's federal capital gain tax (and the income beneficiary receives the benefit of the deduction for state income tax paid on the capital gain).

Section 506(a) 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 because of the fiduciary's income tax election. It is intended to preserve the result reached in *Estate of Britenstool v. Commissioner*, 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. For example, 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 such a rule that applies to trusts where this tax result is unintended and does not apply to trusts where the tax result is intended. Grantors who intend this result rarely state it as an objective in the terms of the trust, but instead rely on the operation of the tax law to produce the desired result. As a result it may not be possible to determine from the terms of the trust 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 terms of the trust. In some situations the IRS may require that such a provision be placed in the terms of the trust as a condition to issuing a private letter ruling.

[ARTICLE] 6
MISCELLANEOUS PROVISIONS

SECTION 601. UNIFORMITY OF APPLICATION AND CONSTRUCTION. In applying and construing this Uniform Act, consideration must be given to the need to promote uniformity in the law with respect to its subject matter among States that enact it.

SECTION 602. SEVERABILITY. If any provision of this [Act] or its application 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 603. REPEAL. The following acts and parts of acts are repealed:

(1) ....

(2) ....

(3) ....

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

SECTION 605. APPLICATION OF [ACT] TO EXISTING TRUSTS AND ESTATES. This [Act] applies to every trust or decedent's estate on and after [the effective date of this [Act]] except as otherwise expressly provided in the will or terms of the trust or in this [Act].