

**UNIFORM PRINCIPAL AND INCOME ACT (199\_)**

**October 11, 1995, Draft**

Section

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[Article] 1

DEFINITIONS AND GENERAL PRINCIPLES

- 101 Definitions
- 102 Fiduciary Duties: General Principles
- 103 Limitation on Fiduciary Liability

[Article] 2

DECEDENTS' ESTATES AND TERMINATING TRUSTS

- 201 Introductory Provisions
- 202 Determination of Net Income
- 203 Distribution of Net Income
- 204 Partial Distributions

[Article] 3

APPORTIONMENT AT THE BEGINNING AND END OF AN INCOME INTEREST

- 301 When Right to Income Begins
- 302 Apportionment of Receipts and Disbursements When  
Decedent Dies or Income Interest Begins
- 303 Apportionment of Receipts and Disbursements When Income  
Interest Ends
- 304 When Payments Are Due

[Article] 4

ALLOCATION OF RECEIPTS DURING ADMINISTRATION OF A TRUST

Part 1

Distributions From Entities

- 401 Definitions
- 402 Character of Distributions
- 403 Other Trusts and Estates
- 404 Business Conducted as a Proprietor

Part 2

Receipts Not Normally Apportioned

- 410 Principal Transactions
- 411 Rental Property
- 412 Obligations to Pay Money
- 413 Insurance Policies and Other Contracts
- 414 Options

Part 3

Receipts Normally Apportioned

- 420 Insubstantial Allocations Not Required
- 421 Deferral Assets
- 422 Deferred Compensation
- 423 Liquidating Assets
- 424 Minerals, Water and Other Natural Resources
- 425 Timber
- 426 Receipts From Sale or Exchange of Unproductive Property
- 427 Derivative Financial Instruments, Arbitrage Activities  
and Similar Assets and Activities

---

[Article] 5

ALLOCATION OF DISBURSEMENTS DURING ADMINISTRATION OF A TRUST

- 501      Disbursements From Income
- 502      Disbursements From Principal
- 503      Transfer From Income to Principal for Depreciation
- 504      Income Taxes
- 505      Equitable Adjustments Between Principal and Income  
         Because of Taxes

[Article] 6

EQUITABLE ADJUSTMENTS

- 601      Trustee's Power to Reallocate

[Article] 7

MISCELLANEOUS PROVISIONS

- 701      Uniformity of Interpretation
- 702      Short Title
- 703      Severability
- 704      Repeal
- 705      Effective Date
- 706      Application of [Act] to Existing Trusts and Estates

## Prefatory Comments

Several sections have been revised extensively:

Section 102 - Fiduciary Duties: General Principles

Section 424 - Minerals, Water and Other Natural  
Resources

Sections 101(a)(4) (which is new), 202(1), 501(a)(5),  
502(a)(4), and 504(a)(5) (environmental expenses)

An alternate section 103 is included to serve as a basis for discussing whether to abandon the idea of a nonjudicial resolution of proposed actions by trustees, and there are numerous other changes throughout the draft. There are also bold face insertions of alternate language, which in most cases have been suggested by others, to which I would like to have the Committee's reactions.

I am still working on sections 426 (unproductive property) and 427 (derivatives, and perhaps moving to that section all of the provisions on options, as well as covering deep discount bonds and high yield bonds), and I may have additional draft material to give you at the meeting. Section 425 (timber) has only minor changes because I have not yet received all of the comments that I expect from people who have called me about that section.

I did not receive the reviewed draft from the Style Committee in time to incorporate their suggestions in this draft.



UNIFORM PRINCIPAL AND INCOME ACT (199\_)

[Article] 1

DEFINITIONS AND FIDUCIARY DUTIES

**SECTION 101. DEFINITIONS.**

(a) In this [Act]:

(1) "Accounting period" means a calendar year or the taxable year for which the fiduciary files a federal income tax return for the trust or estate or a 12-month period for which the fiduciary accounts to a court or beneficiary. The term includes a shorter portion of the accounting period that begins when the income interest begins or ends when the income interest ends.

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

(3) "Deferral asset" means an asset received from a decedent or transferor that is:

(i) a contractual right to receive one or more future distributions from a pension plan, profit-sharing plan, individual retirement account, deferred compensation plan, annuity, or similar arrangement;

(ii) an asset that had not been used by the decedent or transferor or had not produced income during the three-year period before it became subject to the trust if the decedent or transferor had not attempted to make the asset income producing during that period; or

(iii) an asset designated as a deferral asset in the governing instrument.

(4) "Environmental remediation expense" means an expense the fiduciary incurs because the trust or estate owns an asset that is subject to environmental requirements imposed by governmental authority. The term includes disbursements made or required to be made for investigations, studies, clean-up, penalties, and expenses incurred to recover of all or any portion of these disbursements from others. The term does not include expenses incurred because of the operation of a site, the contribution of waste to a site not owned by the trust or estate, or the transportation of waste to such a site.

(5) "Fiduciary" means a personal

representative or a trustee.

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

(7) "Income" means money or property a fiduciary receives during an accounting period as the current return from a principal asset to the extent the receipt became due or accrued during an accounting period in which a current income beneficiary possessed an income interest. The term includes a portion of the receipts from a complete or partial sale, exchange, or liquidation of a principal asset, to the extent provided in [article] 4.

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

(9) "Income interest" means an income beneficiary's right to receive all or part of the net income, either in the accounting period in which the trust receives it or in a later accounting period, whether the governing instrument requires it to be distributed or authorizes it to be distributed in the trustee's discretion. The term also includes the net income accumulated pursuant to a governing instrument if the



instrument permits or requires the trustee to accumulate all or part of the net income.

(10) "Mandatory income interest" means an income beneficiary's right to receive net income that the governing instrument requires the fiduciary to distribute in the accounting period in which the trust receives it or in a later accounting period.

(11) "Net income" means the total receipts **[properly?]** allocated to income during an accounting period minus the disbursements and other items **[properly?]** charged to income during that period. **[Bracketed language suggested by a Commissioner from the floor.]**

( 1 2 ) "Personal representative" includes an executor, administrator, successor personal representative, special administrator, and a person who performs substantially the same function under applicable law.

(13) "Principal" means property held in trust for distribution to a remainder beneficiary when the trust terminates, including undistributed income that is added to principal pursuant to the

governing instrument or Section 303.

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

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

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

"Carrying charge"	Section 426(h)
"Computation period"	Section 426(f)
"Controlled entity"	Section 401(2)
"Deferred compensation"	Section 422(a)
"Delayed income"	
Section 426(e)	
"Due date"	
Section 304	
"Entity"	Section 401(1)
"Inventory value"	
Section 426(d)	

"Liquidating Asset"

Section 423(a)

"Net proceeds"

Section 426(g)

"Partial liquidation"

Section 402(c)

"Successive income interest"      Section 201(a)

"Terminating trust"

Section 201(b)

"Undistributed income"      Section 303(b)

"Unproductive property"      Section 426(a)

#### Comment

A deferral asset described in paragraph (3) would include vacant land held as a long-term investment, stock in a close corporation, undeveloped mineral property, or any other non-income-producing or non-use asset. It would also include a policy providing for the payment of a deferred annuity. Lottery payments and other non-interest-bearing installment payments are intended to be covered by subparagraph (i). It would not include a home, cottage, automobile or other "use" assets.

The purpose for classifying an asset as a deferral asset is to take these assets out of the liquidating asset and unproductive property categories and to deal with them in a separate section.

"Discretionary income beneficiary" and "Discretionary income interest" are not defined because those terms are not used in the Act, but the definitions of income beneficiary (section 101(a)(7)) and income interest (section 101(a)(8)) are broad enough to cover both mandatory and discretionary beneficiaries and interests.

## **SECTION 102. FIDUCIARY DUTIES: GENERAL PRINCIPLES.**

(a) In allocating receipts and disbursements to or between principal and income, and in any other matter **[for which a rule is provided by]** **[within the scope of?]** this [Act], a fiduciary:

(1) must administer a trust or estate in accordance with the provisions of the governing instrument, notwithstanding a contrary provision of this [Act];

(2) may administer a trust or estate by the **[good faith]** **[reasonable?]** exercise of a discretionary power given the fiduciary by the governing instrument even if the fiduciary's exercise of that power results in a determination contrary to a provision of this [Act];

(3) in the absence of a contrary provision or a grant of discretion in the governing instrument, a fiduciary must administer a trust or estate in accordance with the provisions of this [Act]; and

(4) to the extent that paragraphs (1), (2) and (3) do not apply, a fiduciary must administer a trust or estate impartially, based on what is fair and reasonable to all of the beneficiaries and by considering the factors in section 601(b).

(b) If a fiduciary is in doubt about what is fair and reasonable in allocating receipts and disbursements to or between principal and income under the provisions of the governing instrument or Articles 1 through 5 of this [Act], the fiduciary shall resolve the doubt by adding the receipt or charging the disbursement to principal.

(c) If the governing instrument provides that this [Act] does not apply, but contains no provision about a matter for which there is a provision in this [Act] or gives the fiduciary discretion to decide the matter, the fiduciary must be fair and reasonable to all of the beneficiaries unless the governing instrument clearly manifests an intention that the fiduciary must or may favor one or more beneficiaries. A fiduciary who makes a determination in accordance with the provisions of this [Act] is presumed to be fair and reasonable to all of the beneficiaries.

### Comment

\_\_\_\_\_Section 102(a) restates the rule in § 2 of the 1962 Act, without changing its substance, to emphasize that provisions in the governing instrument are paramount. The rules in the Act apply only if the governing instrument has no applicable provision; and if there is no provision in either the governing instrument or the Act, the fiduciary must be impartial in deciding how to allocate a receipt or a disbursement to or between principal and income or in making any other decision on a matter within the scope of the Act. The fact that a person is named as an income beneficiary should not, by itself, be considered an indication of partiality in the governing instrument that should cause a fiduciary to decide that a receipt for which no provision can be found must be allocated to the income beneficiary.

Section 102(a)(2) incorporates the rule in 1962 Act § 2(b) that a discretionary allocation 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.

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

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

**Doubtful questions.** The allocation of doubtful items to principal, as provided in subsection (b), will initially favor

the income beneficiary if the doubtful item is a disbursement, but thereafter it will reduce the income produced by principal. If the doubtful item is a receipt, it will initially favor the remainder beneficiary, but thereafter will favor the income beneficiary by increasing the annual income.

The provision in section 102(c) is intended to establish as a matter of public policy that the rule of impartiality applies even if a governing instrument provides that the Act does not apply if it then fails to provide how a fiduciary should treat a particular receipt or disbursement and also fails to give the fiduciary discretion to decide the question.

### **SECTION 103. LIMITATION ON FIDUCIARY LIABILITY.**

(a) A fiduciary acting in good faith is not liable to a beneficiary for an action taken or a decision made either to act or not to act regarding a matter that is governed by this Act if:

(1) the fiduciary notifies the beneficiary in writing of the proposed action or decision and the date on which it will be implemented, which must be no earlier than 60 days after giving notice;

(2) the notice states that it is pursuant to this section and contains sufficient information to inform the beneficiary of the factual and legal reasons for the action or decision, the facts upon which the fiduciary relies, and an explanation of how the beneficiary will be affected by the action or decision; and

(3) the fiduciary receives no written objection to the proposed action or decision from the beneficiary before the end of the 60-day period that begins when notice is given.

(b) If the fiduciary receives a written objection within the 60-day period, either the fiduciary or a beneficiary may petition the court having jurisdiction over the trust or estate to have the proposed action or decision implemented as proposed, implemented with modifications, or denied. In the proceeding, a beneficiary objecting to the proposed action or decision has the burden of proving that the fiduciary's proposed action or decision should not be implemented. A beneficiary who has not objected is not estopped from opposing the proposed action or decision in the proceeding. If the fiduciary decides not to implement the proposed action or decision, the fiduciary shall notify the beneficiaries of the decision not to implement it and the reasons for that decision. A beneficiary may petition the court to have the action or decision implemented, and has the burden of proving that it should be implemented.

(c) The fiduciary's expenses incurred in formulating the proposed action or decision and invoking the procedure provided for in this section must be allocated to principal and income pursuant to Sections 202, 501, and 502. The



court shall determine whether a beneficiary's expenses are to be charged to the estate or trust and, if so, whether to principal or income.

(d) [Procedural provisions]

(i) Notice to whom. Virtual representation.

(ii) Time within which proceeding must be brought.

Comment

\_\_\_\_\_This new provision is predicated on the notion that the real contest in a principal and income dispute should be between the income and remainder beneficiaries rather than between a beneficiary and the fiduciary (absent bad faith, an intentional wrong or gross negligence) and that a fiduciary should be encouraged to make principal and income decisions based on what is fair and reasonable without having to worry about being surcharged. The fiduciary's proposal is presumptively correct.

No fiduciary is required to proceed under this section, and it applies only if the fiduciary gives a notice stating that it is pursuant to this section. A beneficiary would have the same remedies that he now has if a fiduciary takes an action or makes a decision without using the procedure in this section and a beneficiary feels the fiduciary took the wrong action, made the wrong decision, or failed to act when the beneficiary believes an action or decision was required.

**ALTERNATE SECTION 103 (For consideration by the Drafting Committee)**

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**SECTION 103. PROCEEDINGS FOR INSTRUCTIONS.**

(a) A fiduciary acting in good faith is not liable to a beneficiary for an action taken or a decision made either to act or

not to act regarding a matter that is governed by this Act if the fiduciary petitions the court having jurisdiction over the trust or estate for instructions regarding the proposed action or decision, the petition states that it is pursuant to this section, and it contains sufficient information to inform the beneficiaries of the factual and legal reasons for the action or decision, the facts upon which the fiduciary relies, and an explanation of how the beneficiaries will be affected by the action or decision.

(b) A beneficiary who objects to the proposed action or decision has the burden of proving that it should not be implemented. The court may order that the proposed action or decision be implemented as proposed, implemented with modifications, or denied.

(c) The fiduciary's expenses incurred in formulating the proposed action or decision and in a proceeding under this section must be allocated to principal and income pursuant to Sections 202, 501, and 502. The court shall determine whether a beneficiary's expenses are to be charged to the estate or trust and, if so, whether to principal or income.

(d) This section does not apply to any matter contained in a petition for the approval of a fiduciary's account.

Comment

\_\_\_ This is an alternative to Section 103 in the prior draft, which contemplated a nonjudicial proceeding by a fiduciary but gave a beneficiary the ability to petition the court if he objected to the fiduciary's proposed action or decision. The degree of concern about the procedural aspects of that procedure (including the possible need for virtual representation provisions), and about the possibility that unscrupulous fiduciaries might take advantage of the procedure and use it for purposes not intended by the Act, have caused me to think in less ambitious terms. This provision that deals just with the burden of proof and the allocation of expenses incurred in connection with the procedure.

Perhaps the informal procedure contemplated by the original proposal can be achieved by encouraging fiduciaries to discuss the proposed action or decision informally with the beneficiaries in order to solve any objections they may have before a proceeding is initiated. The proceeding might then proceed by consent.

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[Article] 2

DECEDENTS' ESTATES AND TERMINATING TRUSTS

**SECTION 201. INTRODUCTORY PROVISIONS.**

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

(b) "Terminating trust" means a trust in which a partial or complete termination of an income interest occurs and assets subject to that interest are distributed free of trust or become subject to

one or more successive income interests, or both.

(c) An income interest ends when an income beneficiary dies or another terminating event occurs. An income interest also ends when a trustee who is required or permitted by the governing instrument to accumulate part or all of the net income ceases to be required or permitted to accumulate any net income.

**SECTION 202. DETERMINATION OF NET INCOME.** After a decedent dies, in the case of an estate, or after an income interest ends, the following rules apply:

(1) A fiduciary of an estate or terminating trust shall determine the net income from property specifically given to a beneficiary under the rules in [Articles] 3 through 5 that apply to trustees, but the fiduciary may not subtract from the property's income a disbursement described in section 501 to the extent that the governing instrument or applicable law requires the fiduciary to make the disbursement from assets other than the property or its income, or to the extent that the fiduciary recovers or expects to recover the disbursement from a third party. The property's net income is determined by including receipts and disbursements accrued or due before, on, or after the date of the decedent's death or an income interest's terminating event, and disbursements that the fiduciary will be obligated to make after the property is distributed.

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

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

(ii) excluding from net income all receipts from a sale or liquidation of assets and the collection of accounts receivable that are part of a business conducted by the decedent or the terminating trust; and

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

**SECTION 203. DISTRIBUTION OF NET INCOME.** A fiduciary shall distribute:

(1) to a beneficiary who is to receive specific property, outright or in trust, the net income from the property as determined under Section 202(1);

(2) to a beneficiary who is to receive a pecuniary amount outright, the amount, if any, provided by applicable law or the governing instrument, **[or, if the pecuniary amount is required to be paid from a terminating trust and there is no applicable law or governing instrument provision, the amount, if any, to which the beneficiary would be entitled under applicable law if the pecuniary amount were required to be paid under a will];** and

(3) to all other beneficiaries, including a trust that receives a pecuniary amount, the balance of the net income. Each beneficiary shall receive a percentage of the net income equal to the beneficiary's percentage interest in the estate or trust after deducting gifts described in paragraphs (1) and (2), using values as of the distribution date. The beneficiaries to which this paragraph applies includes even though a beneficiary of the trust holds an unqualified power to withdraw assets from the trust or another form of presently exercisable general power of appointment over the trust.

Comment

\_\_\_\_\_The distinction in this section between outright pecuniary

bequests and those made in trust is taken from Section 5(b)(2) of the 1962 Act.

Section 203(2) provides for the beneficiary of an outright pecuniary amount to receive the interest or other amount provided by applicable law, but it does not provide for the situation in which there is no applicable law or governing instrument provision, and in particular where there is a provision dealing with gifts in a will, but not gifts appearing in an inter vivos trust agreement. The consensus of the Drafting Committee at our last meeting was that, since many states now have applicable provisions, at least as to pecuniary bequests in wills, this question should be resolved on a state by state basis to avoid the possibility that a provision in this Act might overlap or be inconsistent with existing law. The bold face language is proposed for the purpose of reconsidering this question.

David English, Reporter for the Uniform Probate Code, has suggested that the provision for the payment of interest on outright pecuniary legacies should be in this Act rather than in the probate code. If we do this, the provision could cover pecuniary gifts under both wills and revocable living trust agreements. UPC section 3-904 now provides: "General pecuniary devises bear interest at the legal rate beginning one year after the first appointment of a personal representative until payment, unless a contrary intent is indicated by the will."

If there is no provision in this Act, the problem that should be addressed in each state is that applicable law for paying interest on pecuniary gifts may apply only to pecuniary bequests under wills and not to pecuniary gifts payable from inter vivos trusts, especially revocable living trusts used as will substitutes. The various state authorities that provide for the amount that a beneficiary of an outright pecuniary amount is entitled to receive are collected in Covey, Marital Deduction and Credit Shelter Dispositions and the Use of Formula Provisions, App. B (Supp. 1993).

#### **SECTION 204. PARTIAL DISTRIBUTIONS.**

(a) If a fiduciary makes more than one distribution of assets to beneficiaries who are to receive net income pursuant to Section 203(3), all of those beneficiaries, including those who do not receive part of the distribution, are entitled, as of each distribution date, to the net income the fiduciary has received, **and the net gain [or loss?] realized**, after the date of death or terminating event or earlier distribution date but has not distributed

as of the current distribution date. In determining a beneficiary's share of net income:

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

(2) the beneficiary's interest in the undistributed principal assets shall be computed on the basis of the aggregate fair market value of those assets as of the distribution date without reducing the value by any principal obligation that has not been paid as of the distribution date. For the purpose of this section, the distribution date shall be the date as of which the fiduciary computes the fair market value of the assets, which may be a date reasonably near the date on which assets are actually distributed.

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

Comment



If all of the assets are distributed at one time, after administration of the estate or terminating trust is complete, section 204 does not apply. Section 204 applies only if partial distributions are made before the final distribution. If no partial distributions are made, all of the income earned during administration will be distributed on the basis of the fractional interests in the property that exist when the final distribution is made. It also applies only to income and not to gains realized during the administration from the sale or other disposition of principal asset. Those gains (and losses) become part of the final residue to be distributed when administration is complete, based on the final fractional interests the beneficiaries have in the estate or terminating trust.

Impartiality does not require a fiduciary to make interim distributions to beneficiaries as administration progresses even though their interests in the income would be different if distributions were made from time to time; nor does it require a fiduciary to make book allocations of income as changes in beneficial interests occur because the fiduciary sells assets or pays debts, taxes and expenses. Any such requirement would make administration much more complex.

Section 204(a) is intended to include a distribution that a fiduciary makes to some but not all of the beneficiaries described in Section 203(3) as well as a non-pro rata distribution to all of the Section 203(3) beneficiaries.

The Act does not contemplate a need to change the proportions used in making a distribution of income even though values for the assets may be changed due to an IRS audit of an estate tax return.

The 1962 Act uses inventory value to determine beneficiaries' rights in the undistributed assets; subsection 204(a)(2) changes that to fair market value.

The provisions in section 204 are intended to make it clear that the "gross-net share" method (using the terminology Covey used in an article at 2 Real Prop., Prob. and Tr. L. J. 1, 8-9 (1967)) is to be used in determining the amount of income due to residuary beneficiaries and recipients of pecuniary gifts in trust; that no redeterminations are to be made of their respective shares in net income just because assets are sold and principal obligations are paid between the times when distributions are made to beneficiaries; and that no principal or income receipts or disbursements are to be accrued or anticipated in computing net income when a distribution is made. In other words, a strict cash receipts and disbursements method of accounting is to be applied.

[Article] 3

APPORTIONMENT AT BEGINNING AND END OF INCOME INTEREST

**SECTION 301. WHEN RIGHT TO INCOME BEGINS.**

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

(b) An asset becomes subject to a trust or a successive income interest:

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

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

(3) on the testator's date of 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

(4) on the date the preceding income interest ends in the case of an asset that becomes subject to a successive income interest, even if there is an intervening period for the winding up of the terminating trust.

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

(a) A receipt that would be income under [Article] 4 must be allocated to principal if it is due before a decedent dies or before the principal asset that produces the receipt becomes subject to a trust unless it is a receipt from property to which Section 202(1) applies.

(b) A disbursement must be charged to principal if it is made to pay an obligation that is due before a decedent dies or an asset becomes subject to a trust.

(c) Income or obligations that are not due when a decedent dies or an income interest begins must be treated as accruing from day to day. The portion of the income or obligation accruing before that

date is principal and the balance is income.

#### Comment

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

Having two different rules is confusing. In order to simplify administration, Section 302 applies the same rule to inter vivos trusts (revocable and irrevocable), testamentary trusts and assets that become subject to an inter vivos trust through a pour-over bequest in a will. There is no apparent policy reason for the 1962 Act distinction, and Professor Bogert does not explain why different rules should apply.

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

Interest accrued before a person dies or a trust begins 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 unless the obligation is specifically given to a devisee or remainder beneficiary, in which case subsection 202(1) would give the accrued income to the person who receives the obligation.

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

(a) When a mandatory income interest ends, a mandatory income beneficiary who survives that date or the estate of a deceased mandatory income beneficiary whose death causes the interest to end is entitled to the beneficiary's share of the undistributed income that is not disposed of by the governing instrument, but undistributed income from assets or the proceeds of assets that a mandatory income beneficiary transferred to the trust must be added to principal.

(b) "Undistributed income" means the net income that has been received before the month in which an income interest ends but has not been distributed to an income beneficiary or added to principal or is not required to be added to principal pursuant to the terms of the governing instrument. The term does not include net income from property to which Section 202(1) applies.

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Comment

The definition of undistributed income in subsection (b) is different from the provision in Section 4(d) of the 1962 Act. Under Section 303(b), items that are due or that have accrued are excluded from the definition of undistributed income. The requirement that undistributed income include only net income received is also intended to exclude "accruals" of items such as the increment in value that may have occurred on zero coupon bonds.

Both the 1931 Act (Section 4) and the 1962 Act (Section 4(d)) provide that a deceased income beneficiary's estate is entitled to the undistributed income. The Drafting Committee concluded that this is probably not what most settlors would want, and that most settlors would probably favor the income beneficiary first, the remainder beneficiaries second, and the income beneficiary's heirs

last, if at all. However, it decided not to eliminate this provision completely to avoid causing disputes about whether the trustee should have distributed collected cash before the income beneficiary died.

The provision at the end of subsection (a) applies to the undistributed income in a revocable living trust when the grantor who is also the income beneficiary dies.

**SECTION 304. WHEN INCOME OR OBLIGATIONS ARE DUE.** An item of income or an obligation is due on the date on which the payor is required to make a payment. If there is no stated payment date, there is no due date for the purposes of this [Act]. Corporate distributions to stockholders are deemed to be due on the date fixed by the corporation for determination of stockholders of record entitled to distribution or, if no date is fixed, on the declaration date for the corporate distribution.

[Article] 4

ALLOCATION OF RECEIPTS DURING ADMINISTRATION OF TRUST

[Part] 1

Distributions From Entities

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**SECTION 401. DEFINITIONS.**

(1) "Entity" includes a corporation, partnership, limited liability company, regulated investment company, real estate investment trust, common trust fund, business that a trustee accounts for as an entity under Section 404, another estate or trust, and any other organization in which the trustee owns an equity interest. The term does not include a tenancy in common or an entity that acts as an agent or nominee for the trustee.

(2) "Controlled entity" means an entity in which a trustee owns an interest that enables the trustee to terminate the entity's existence or to withdraw the trust's pro rata share of the entity's assets.

#### Comment

The definition in paragraph (2) is not used in any substantive provision of this draft, but is included for the purpose of discussing whether the Act should have a look-through provision for the purpose of (for example) treating distributions from an entity that owns wasting assets as though the trustee directly owned those assets.

### **Section 402. CHARACTER OF DISTRIBUTIONS.**

(a) Except as otherwise provided in subsection (b), all distributions from an entity are income, including a distribution chosen when the distributing entity gives the trustee an option to receive a distribution either in cash or in its own shares or other units of equity.

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

(1) a distribution of its own shares or other units of equity, securities or obligations, including a distribution in the form of a stock split or stock dividend or a comparable distribution from a noncorporate entity;

(2) a distribution of shares, other units of equity, securities or obligations of an entity other than the distributing entity;

(3) a distribution of rights to subscribe to shares, other units of equity, securities, or obligations of the distributing entity or another entity and the proceeds of those rights;

(4) a distribution from an entity that is a regulated investment company or a real estate investment trust if it is a capital gain dividend for federal income tax purposes whether in the form of cash or additional stock; and

(5) except to the extent that an entity indicates that some part of a distribution is a settlement of preferred or guaranteed amounts accrued since the trustee became an owner, a distribution that is pursuant to:



(i) a call of shares or other units of equity ownership;

(ii) a merger, consolidation, reorganization, or other plan by which assets of the entity are acquired by another entity; or

(iii) a total or partial liquidation of the entity.

(c) "Partial liquidation" means:

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

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

(3) a distribution of assets, other than cash, pursuant to a court decree or final administrative order by a government agency ordering distribution of the particular assets.

(d) A distribution is not a partial liquidation to the

extent it is made to provide cash to a beneficiary to pay an income tax obligation on the entity's undistributed taxable income, nor is it a partial liquidation solely because the entity has realized a gain from the sale of investment assets or of business assets not held for sale to customers in the normal course of its business.

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

#### Comment

Under the Internal Revenue Code and the Income Tax Regulations, a "capital gain dividend" from a mutual fund or an REIT is the excess of the fund's net long-term capital gain over its net short term capital loss. As a result, a fund's capital gain dividend does not include any net short-term capital gain. Moreover, it is frequently difficult or impossible to obtain any information about the extent to which a fund has actually distributed any net short-term capital gain it may have realized. The Committee has continued the treatment of capital gain dividends as principal, but no inference should be drawn that distributions from other entities that have their origin in an entity-level transaction that results in long-term capital gain for income tax purposes is principal for the purposes of this Act. (See subsection (e)).

**SECTION 403. OTHER TRUSTS AND ESTATES.** Income includes income received from another trust in which the trust has an income interest because of a donative transfer, including income to which Section 203 applies. Principal includes a distribution from principal of another

trust in which a trustee has a beneficial interest because of a donative transfer. If a trustee transfers principal assets to a trust that is an investment entity in exchange for a beneficial interest in that entity, or if a decedent or donor transfers a beneficial interest in such a trust to a trustee, Section 402 applies to distributions from that trust.

Comment

An investment entity to which 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 managing investment assets.

**SECTION 404. ACTIVITIES CONDUCTED AS A PROPRIETOR.**

(a) If a trustee uses part of the principal in the conduct of a business or other activity for which the trustee considers it necessary or desirable to account separately for its receipts, disbursements, accounts receivable, accounts payable, inventories, or invested capital, the trustee may account for those transactions as though the business or activity were an entity separate from but wholly owned by the trust.

(b) A trustee may determine the extent to which net cash receipts from the conduct of a business in an accounting period must be retained for working capital, the acquisition or replacement of fixed assets, and other reasonably foreseeable needs of the business. The trustee shall transfer the remaining net cash receipts to the

trust's general income account.

(c) Net cash receipts from a sale of business assets not in the ordinary course of business must be transferred to trust principal to the extent the trustee determines they are no longer required in the conduct of the business.

(d) Activities for which the trustee may account pursuant to this section include farming operations, management of rental properties, extraction of natural resources, timber operations, and activities described in Section 427. The trustee may aggregate in one or more entities described in subsection (a) as many separate business activities as the trustee considers appropriate.

#### Comments

These provisions are intended to give more appropriate powers to a trustee who operates a business in proprietorship form. Section 404 would also permit (but not require) a trustee to account for rental properties and oil and gas properties as though they were held by a separate entity.

If a fiduciary liquidates a sole proprietorship during probate or during a trust's winding-up period, section 202(2)(ii) requires the proceeds to be added to principal.

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#### [Part] 2

#### Receipts Not Normally Apportioned

**SECTION 410. PRINCIPAL RECEIPTS.** Principal includes:

(1) assets received from a transferor during the transferor's lifetime, a decedent's estate, a terminating trust, or a payor pursuant to a contract naming the trust or its trustee as beneficiary, to the extent those assets are not income under Section 202 or 403;

(2) cash or other property received from the sale, exchange, or liquidation of a principal asset, including profit realized in such a transaction, subject to the provisions in [Part] 3 of [Article] 4;

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

(4) money or property received that became due or accrued during an accounting period in which no current income beneficiary had an income interest; and

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

#### Comment

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

**SECTION 411. RENTAL PROPERTY.** An amount received as rent

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

#### **SECTION 412. OBLIGATIONS TO PAY MONEY.**

(a) An amount received as interest on an obligation to pay money to the trustee, including an amount received as consideration for the privilege of prepaying principal, is income. An amount received from the sale, redemption, or other disposition of such an obligation is principal. Provision may not be made for amortization of premium or for accumulation of discount on an obligation that provides for payment of interest at least annually if the premium or discount occurs because of market changes in the obligation's price.

(b) If an obligation provides for payment at a future time of an amount greater than the price at which it was issued, the increment in value is determined and distributable as income in the following manner:

(1) The increment in value for each accounting period must be determined from a fixed schedule of appreciation if one

is established for that obligation. If no fixed schedule is established, the increment must be the amount of original issue discount that the trustee is required to report for federal income tax purposes for that accounting period.

(2) A beneficiary who has a mandatory income interest during the accounting period when the increment accrues is entitled to receive an amount equal to the increment from the first principal cash available or, if none becomes available earlier, when the increment is realized by sale, redemption, or other disposition of the obligation, but:

(i) the trustee is not required to distribute any amount from principal if the trustee is in doubt about the obligor's ability to pay the obligation in full when due or if the market value of a readily marketable obligation is less than the price at which it was issued plus the accrued increments;

(ii) the right of an income beneficiary or that beneficiary's estate to receive the increment terminates when that beneficiary's mandatory income interest terminates; and

(iii) when an obligation's increment is realized, principal must be reimbursed from that increment for amounts distributed from principal pursuant to this paragraph because of that obligation before any part of the increment is added to income.

(c) If the amount distributed pursuant to subsection (b) (2) exceeds the increment, principal may not be reimbursed for that excess from any other source.

(d) This section does not apply to obligations to which Sections 421 through 423, 426 and 427 apply.

#### Comment

This section is intended to apply to bonds and to promissory notes that evidence an obligation to repay borrowed money or to pay the balance of an asset's purchase price. It is not intended to apply to money under a notional principal contract or any other derivative financial instrument to which Section 427 applies.

### **SECTION 413. INSURANCE POLICIES AND OTHER CONTRACTS.**

(a) Insurance proceeds are principal if they are 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. Dividends received from an insurance policy are principal and the proceeds of any other contract in which the trust or its trustee is named as beneficiary are principal. This section does not apply to a contract to which Section 422 applies.



(b) Insurance proceeds are income if they are from a policy that insures the trustee against the loss of occupancy or other use by an income beneficiary, the loss of income, or, subject to Section 404, the loss of profits from a business.

**SECTION 414. OPTIONS.** If a trustee grants, acquires or exercises an option in circumstances to which Section 427 does not apply:

(1) An amount received from granting an option to buy property from a trustee, whether or not the trustee owns the property when the option is granted, must be held as part of the trust principal until the option expires or is exercised. The amount is income if the option is not exercised and is part of the sales proceeds if the option is exercised.

(2) A gain realized upon the exercise of an option granted as compensation or upon a later sale of the property acquired by the exercise of the option is principal.

(3) An amount disbursed to acquire an option to sell an asset owned by the trustee must be paid from principal, whether or not the option is exercised.

#### Comment

This section applies to occasional option transactions and not to options granted or acquired in connection with arbitrage or hedging activities or dealings in derivative financial instruments. It applies to an option to purchase real estate owned by the trustee in an isolated real estate transaction and to 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. A

continuing and regular practice of selling call options on securities owned by the trust is subject to Section 427.

This section does not apply to an agreement between owners of an entity who grant options to each other to buy or sell their interests in the entity if an owner dies, retires or wants to transfer part or all of his interest in the entity; nor would it apply to any other option if the consideration received or given for the option were not cash or property.

### [Part] 3

#### Receipts Normally Apportioned

**SECTION 420. INSUBSTANTIAL ALLOCATIONS NOT REQUIRED.** If a trustee determines that an allocation required by Sections 421 through 427 is insubstantial, the trustee may make such an allocation but is not required to do so. If the trustee decides not to allocate a receipt between principal and income because it is insubstantial, the receipt must be added to principal. An allocation is presumed to be insubstantial if:

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

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

#### Comment

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

**SECTION 421. DEFERRAL ASSETS.** If the governing instrument does not provide a method for allocating receipts from a deferral asset to or between principal and income:

(1) receipts from a fixed or variable annuity arrangement, including a deferred annuity, whether received from an employer, a company that issues annuity contracts, or any another source, are allocated to principal and income in the manner described in section 422 (c) and (d); and

(2) receipts from any other deferral asset shall be added to principal.

**SECTION 422. DEFERRED COMPENSATION.**

(a) "Deferred compensation" means an amount receivable for personal services under an arrangement for the payment of compensation in a year after the year in which the services were performed, whether the obligation to pay is funded or unfunded. The term includes insurance policy renewal commissions and the right to receive distributions from an individual retirement account or a pension or profit sharing plan, including an account or plan to which the person performing the services made contributions.

(b) If interest is required to be paid at least annually on the unpaid principal balance, the interest is income and all other receipts are principal.

(c) If the arrangement permits the trustee to take the deferred compensation in a single payment and the trustee elects to do so, the receipt is principal. If the arrangement provides for installment payments over a period of years that is a fixed term or a term based on an individual's remaining life expectancy, and if it permits the trustee to withdraw amounts in excess of the regular installment payments, an excess withdrawal is principal.

(d) In all other cases the trustee shall allocate [20] percent of the receipts to income if the trustee expects the full amount to be paid over a fixed period of more than five years after the asset becomes subject to the trust or successive income interest, or over an indefinite period, such as a life expectancy, that the trustee expects to be more than 5 years. The trustee shall allocate [10] percent of the receipts to income if the trustee expects the full amount to be paid over a fixed or indefinite period of 5 years or less after the asset becomes subject to the trust or successive income interest. In each case, the balance of the receipts must be allocated to principal. In determining the number of years over which payments may be made, any power of the trustee to shorten the period by withdrawing additional amounts must be ignored.

Comment

Under Section 422(d), if an income interest terminates and unpaid deferred compensation becomes subject to a successive income interest, the time period is redetermined.

**SECTION 423. LIQUIDATING ASSETS.**

(a) "Liquidating asset" means an asset whose value will diminish or terminate because the asset is expected to produce receipts for a period of limited duration. The term includes leaseholds, patents, trademarks, copyrights, royalty rights, and rights to receive payments during a period of more than one year under an arrangement that does not provide for the payment of interest on the unpaid balance. The term does not include a deferral asset that is subject to Section 421, deferred compensation that is subject to Section 422, natural resources that are subject to Section 424, timber that is subject to Section 425, activities that are subject to Section 427, or any asset for which the trustee establishes a reserve for depreciation under Section 503.

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

percent if for five years or less, and shall allocate the balance to principal.

(c) If the trustee knows or can readily determine from information made available by an entity that a distribution from the entity is made in whole or in part from receipts produced by a liquidating asset owned by the entity, the trustee may allocate the distribution to or between principal and income under this section instead of Section 402 if the trustee determines that it produces a result fairer to the income beneficiary or the remainder beneficiary to do so.

#### Comment

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. It is essentially a provision to pay a fixed annuity to the income beneficiary until the asset is exhausted. The balance of each year's receipts is added to principal where it is reinvested and produces additional income. The remainder beneficiary receives all of the receipts from unexpected growth. Conversely, if the actual receipts diminish more rapidly than expected, most of the payments will go to income and little to principal. Section 423 abandons the annuity approach.

The reference in subsection (a) to "rights to receive payments" with no separately stated interest covers state lottery prizes and similar fixed amounts payable over time that are not deferred compensation arrangements covered by Section 422.

#### **SECTION 424. MINERALS, WATER AND OTHER NATURAL RESOURCES.**

(a) An amount received because the trust owns an interest

in minerals or other natural resources must be allocated as follows:

(1) If received as annual rent **[Alternate language: nominal delay or annual rent]** on a lease, it is income.

(2) If received from a production payment, it is income to the extent that the agreement creating the production payment provides a factor for interest or its equivalent. The balance is principal.

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

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

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

(c) This section applies to interests in minerals, water or other natural resources acquired by a trust after this [Act] takes effect, whether or not acquired when the trust was established, and whether or not minerals or other natural resources were being extracted when the trust was established. If the trust owns an interest in minerals, water or other natural resources when this [Act]



takes effect, the trustee must allocate receipts from the interest in the manner used by the trustee before this [Act] takes effect.

**[Alternate: (c) This section applies to interests in minerals, water or other natural resources acquired by a trust before or after this [Act] takes effect. If the minerals or other natural resources were acquired when the trust was established, this [Act] applies whether or not they were being extracted at that time. If the trust owns an interest in minerals, water or other natural resources when this [Act] takes effect, the trustee may allocate receipts from the interest as provided in this section or in the manner used by the trustee before this [Act] takes effect.]**

#### Comment

The 1962 Act allocates 27-1/2% of the gross receipts (but not more than 50% of the net receipts after paying expenses) to principal as a depletion allowance. 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 424 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.

#### **SECTION 425. TIMBER.**

(a) Net receipts from the harvesting and sale of timber

owned by a trust must be allocated:

(1) to principal if the timber is removed as a result of commercial exploitation or by clear cutting that occurs at irregular intervals;

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

(3) if the rate of harvesting occurs regularly but exceeds the tract's rate of growth, to income to the extent of the tract's normal rate of growth, and the balance to principal.

(b) Net receipts from the lease of timberland or from a contract to cut timber from land owned by a trust must be allocated to principal to the extent the timber removed from the land reduces the quantity of available timber below the quantity at the beginning of the lease or contract, and the balance to income.

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

**SECTION 426. RECEIPTS FROM SALE OR EXCHANGE OF UNPRODUCTIVE PROPERTY.**

(a) "Unproductive property" means a principal asset that has not produced an average net income of at least [one] percent per year of its inventory value during the computation period, but unproductive property does not include:

(1) a readily marketable stock or bond paying cash dividends or interest at least annually;

(2) an interest in a regulated investment company, real estate investment trust, investment partnership or similar investment entity;

(3) real or tangible personal property that is used or available for use by an income beneficiary during a substantial part of the computation period;

(4) an asset used by the trustee in an activity accounted for under Section 404 during the computation period;

(5) stock redeemed by a corporation or funds withdrawn from a partnership to the extent the aggregate amount received in one or a series of such distributions does not exceed the total death taxes, funeral and administration expenses incurred because of an individual's death;

(6) a life insurance policy or its proceeds;

(7) a deferral asset; and

(8) an asset not described in paragraphs (1) through (7) to which subsection 412(b) (debt obligations issued at a discount), Sections 413, 414, 421 through 425, and 427 apply.

(b) If, before a beneficiary's income interest ends, unproductive property is sold or exchanged for money and property that can be apportioned easily, a portion of the net proceeds must be allocated to income to the extent that the delayed income, plus the carrying charges paid from income during the computation period, exceeds the net income from the property that was required to be distributed to the income beneficiary during the computation period. The balance of the net proceeds is principal. If unproductive property is sold on an installment basis, the amount that is allocated to income must be paid pro rata from the net proceeds received upon closing and the deferred balance as it is received. If a mandatory income interest ends after the sale or exchange but before the trustee receives all of the proceeds, only the portion of the delayed income payable from the net proceeds collected must be allocated to income.

(c) This section applies whether or not the trustee has a duty to make the asset productive. This section does not apply to the extent that unproductive property is exchanged for property that cannot be apportioned easily. If the substituted property is converted into cash or easily apportionable property before the beneficiary's income interest ends, a right to delayed income must be computed by treating the substituted property as having

been unproductive during the computation period for the original property.

(d) "Inventory value" means an asset's adjusted basis for federal income tax purposes, but:

(1) If an asset is included in a decedent's estate and becomes subject to a trust because of the decedent's death, and if the income tax basis of that asset is different from its value for estate or inheritance tax purposes, the trustee may use its estate or inheritance tax value. If the asset is not subject to estate or inheritance tax and its income tax basis is different from its probate inventory value, the trustee may use its probate inventory value.

(2) If an asset does not become subject to a trust because of an individual's death, the trustee may use the asset's fair market value at the time it becomes subject to the trust, including any value finally determined for gift tax.

(e) "Delayed income" means the amount by which the net proceeds exceeds the amount that would have produced the net proceeds if it had been invested at [4] percent per year simple interest and had accrued from day to day during the computation period.

(f) "Computation period" means a period beginning with the first accounting period in which the asset was subject to the trust and the income beneficiary possessed an income interest, and ending with the accounting period in which the asset is sold.

(g) "Net proceeds" means an amount equal to the total of the money and the value of easily-apportioned property received, determined as of the time of sale, less expenses of the sale, any tax imposed on the trustee because of the sale, and carrying charges paid from either principal or income during the computation period.

(h) "Carrying charge" includes property taxes imposed on the asset and interest on debt secured by the asset, but it does not include any portion of the trustee's normal fees.

(i) If less than all of a liquidating asset is sold or exchanged, and the average net income from the portion sold, exchanged, or liquidated has been less than one percent of its pro rata share of the inventory value during the computation period, this section applies only to that portion.

(j) A governing instrument must not be construed to be contrary to this section because it permits a trustee to retain assets transferred to the trust by a decedent or transferor or exonerates the trustee for a failure to diversify the portfolio unless the governing instrument contains other provisions that show a clear intent to deny an income beneficiary the right to delayed income.

(k) Sales proceeds from property that is described in subsection (a) shall not be apportioned between principal and income.

#### Comment

\_\_\_\_ A "readily marketable" stock or bond referred to in Section 426(a)(1) is one with trading volume sufficiently large to absorb the trust's holding within a reasonable period after it is offered on the market. Having only buy and sell quotations from the pink sheets is not enough to make a stock readily marketable.

\_\_\_\_ An installment note or a contractual obligation to pay installments is property that can be apportioned easily for purposes of subsection (c). Land acquired by or in lieu of foreclosure or in a tax-free exchange is property that cannot be apportioned easily.

Inventory value (subsection 426(d)), is now important under the Act only in determining if the unproductive property provisions in Section 426 apply. While it would be used in determining profit or loss on the disposition of a principal asset, that is not a calculation of significance for principal and income purposes because all of the gross receipts are included in principal (under section 410(2)) or are apportioned between income and principal using a method that does not depend on whether a profit has been realized.

In most cases, an asset's adjusted basis for federal income tax purposes is its fair market value determined for federal estate tax purposes (as of the date of death or the alternate valuation date) or, if no federal estate tax return is required, the value as of the date of death for state inheritance tax purposes. Inc. Tax. Reg. § 1.1014-3(a). Section 426(d)(2) applies to any asset whose income tax basis does not change to its estate tax value; under present law, this includes income in respect of a decedent, certain stock options and property received by gift within one year prior to death.

It is possible for the income tax basis of a trust asset to change to an estate tax value even though the trust doesn't terminate (e.g., if the grantor of an irrevocable trust retains a power that causes the trust assets to be included in his estate), and the provision in section 426(d) will cause the inventory value to change if that occurs.

#### **SECTION 427. DERIVATIVE FINANCIAL INSTRUMENTS, ARBITRAGE AND HEDGE ACTIVITIES.**

(a) If, as part of a continuing and regular practice, a trustee enters into one or more contracts that are derivative financial instruments, engages in arbitrage, hedge or similar activities, [60] percent of the net gain or loss from these activities shall be allocated to income and [40] percent to principal. Net gain

or loss is determined by taking into account interest, transaction and other costs related to the activities. A gain or loss that occurs because the trustee marks securities to market or other value during an accounting period shall not be considered gain or loss for purposes of this section.

(b) If the trustee lends securities, sells securities short, or sells options to sell securities the trustee does not own, [60] percent of the net gain or loss from the transaction shall be allocated to income and [40] percent to principal.

#### Comment

The derivative financial instruments to which this section applies include futures, forward, swap or option contracts or other financial contracts with similar characteristics.

The 60%/40% allocation is derived from assumptions about the trustee's yield objectives in investing the traditional portion of the portfolio. If we assume the trustee's traditional portfolio objectives are to invest 65% of the assets in equities and 35% in fixed income securities, and to obtain the 1926-1991 averages for income and capital appreciation shown in Ibbottson Associates' Stocks, Bonds, Bills, and Inflation 1992 Handbook (5.4% income from the equities and 5% capital appreciation; and 5.4% income from long-term corporate bonds) income is 59.4% of the total return and capital appreciation is 40.6%.

Different assumptions produce different results. If we assume a higher capital appreciation and a lower dividend yield from equities, and a higher yield from long-term corporate bonds (to reflect patterns of the last 20 years), the ratios move to the 53.3%/46.7% range. A 50%/50% allocation could also be used as the default percentages. In addition, the trustee could be authorized to proceed under section 103 and notify the beneficiaries of the percentages that it proposes to use if the trustee feels that they provide a fairer result for the beneficiaries than the default provisions in this section.

Section 427 does not apply to receipts from an entity that engages in activities to which this section applies. Distributions from the entity are income or principal under Section 402(c).



[Article] 5

ALLOCATION OF DISBURSEMENTS DURING ADMINISTRATION OF A TRUST

**SECTION 501. DISBURSEMENTS FROM INCOME,**

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

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

(4) premiums on insurance covering the loss of a

principal asset or the loss of income from or use of the asset; and

(5) environmental remediation expenses, but only to the extent that those expenses do not exceed the net income received from the property for which the remediation expenses were incurred after deducting all other expenses directly attributable to that property.

#### Comment

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

### **SECTION 502. DISBURSEMENTS FROM PRINCIPAL.**

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

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

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

(3) principal payments of a trust debt;

(4) environmental remediation expenses not paid from income under section 501(a)(5), other expenses incurred to comply with applicable environmental laws, and penalties imposed under those laws;

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

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

(7) estate, inheritance and other transfer taxes, including penalties, apportioned to the trust.

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

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

### Comment

Expenses incurred to comply with environmental laws include the cost of administrative proceedings and burdens of every kind imposed as the result of an administrative or judicial proceeding, even though not formally characterized as a penalty.

Expenses described in subsection(a)(5) are intended to include the "action to assure title" that is mentioned in Section 13(c)(2) of the 1962 Act.

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)(7).

### **SECTION 503. TRANSFER FROM INCOME TO PRINCIPAL FOR DEPRECIATION.**

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

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

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

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

(3) of property held by the trustee when this [Act] takes effect for which the trustee is not then making an allowance for depreciation unless a transfer is permitted as a result of a proceeding described in Section 103.

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

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

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

#### Comment

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

The Drafting Committee concluded that depreciation should be discretionary. For those trustees who elect to provide for depreciation, additional provisions in this draft describe how it may be determined. The reference to generally accepted accounting principles has been deleted.

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

Section 503(b)(2) carries forward a provision in the 1962 Act that prohibits the retroactive application of the depreciation provision. It applies only to property held by a trustee on the effective date of this Act if the trustee was not then making an allowance for depreciation. This would apply both in states whose prior law did not provide for depreciation and in 1962 Act states where trustees were not making allowances for depreciation even though the Act does provide for it. However, even in these cases depreciation can be taken if it is permitted by a proceeding under Section 103 of this Act.

#### **SECTION 504. TRANSFERS FROM INCOME TO REIMBURSE PRINCIPAL.**

(a) If a trustee makes or expects to make a principal

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

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

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

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

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

(5) costs incurred to comply with applicable environmental laws other than penalties, costs incurred to defend against the imposition of penalties, and any other disbursement that does not contribute materially to the property's income-producing ability.

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

#### **SECTION 505. INCOME TAXES.**

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

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

(c) A tax required to be paid by a trustee because of taxable income from an entity in which the trust or estate owns an interest must be paid from principal if:

(1) the entity has not distributed the income to the trust or estate in or before the accounting period in which the trustee pays the tax; or

(2) the tax resulted from the sale by the entity, other than in the normal course of business, of a non-inventory fixed asset used in the entity's business, or from the sale of an asset not used in the entity's business that would be a



principal asset if the trustee owned it directly, without regard in either case to whether the entity has distributed any or all of the sales proceeds to the trustee.

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

(a) A trustee may make adjustments between income and principal as the trustee considers appropriate to compensate for any shifting of economic interests or tax benefit between income and remainder beneficiaries occurring because:

(1)               of elections and decisions that the trustee may make from time to time regarding tax matters;

(2)               federal income tax or any other tax is imposed upon the trustee or a beneficiary as a result of a transaction involving the trust or a distribution from the trust; or

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

(b)               A trustee shall transfer from income to principal an amount equal to the decrease in a marital deduction or a charitable contributions deduction that occurs because the trustee elects under applicable federal or state law to deduct on an income tax return instead of an estate tax return an amount that is paid from or chargeable to principal, if the trustee's election causes an

increase in the estate tax and a decrease in the amount of principal that would be eligible for a marital deduction or charitable contributions deduction.

[Article 6]

EQUITABLE ADJUSTMENTS

**SECTION 601. TRUSTEE'S POWER TO REALLOCATE.**

[Article 7]

MISCELLANEOUS PROVISIONS

**SECTION 701. UNIFORMITY OF INTERPRETATION.**

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

**SECTION 702. SHORT TITLE.**

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

**SECTION 703. SEVERABILITY.**

If any provision of this [Act] or the application thereof to any person or circumstance is held invalid, the invalidity does not

affect other provisions or applications of this [Act] which can be given effect without the invalid provision or application and to this end the provisions of this [Act] are severable.

**SECTION 704. REPEAL.**

The following acts and parts of acts are repealed:

(1)

(2)

(3)

**SECTION 705. EFFECTIVE DATE.**

This [Act] takes effect on .....

**SECTION 706. APPLICATION OF [ACT] TO EXISTING TRUSTS AND ESTATES.**

Except as expressly provided in the governing instrument or in this [Act], this [Act] applies to any receipt or expense received or incurred by any trust or decedent's estate after this [Act] takes effect.