D R A F T

FOR DISCUSSION ONLY

REVISED UNIFORM PRINCIPAL AND INCOME ACT

[TENTATIVE NEW NAME: UNIFORM TRUST INCOME AND PRINCIPAL ACT]

NATIONAL CONFERENCE OF COMMISSIONERS

ON UNIFORM STATE LAWS

March 24-25, 2017 Drafting Committee Meeting

The ideas and conclusions set forth in this draft, including the proposed statutory language and any comments or reporter's notes, have not been passed upon by the National Conference of Commissioners on Uniform State Laws or the Drafting Committee. They do not necessarily reflect the views of the Conference and its Commissioners and the Drafting Committee and its Members and Reporter. Proposed statutory language may not be used to ascertain the intent or meaning of any promulgated final statutory proposal.

March 3, 2017

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REVISED UNIFORM PRINCIPAL AND INCOME ACT

TABLE OF CONTENTS

[ARTICLE] 7
APPORTIONMENT AT BEGINNING AND END OF INCOME INTEREST

[ARTICLE] 8
ALLOCATION OF RECEIPTS DURING ADMINISTRATION OF TRUST

[PART 1
RECEIPTS FROM ENTITIES]

[PART 2
RECEIPTS NOT NORMALLY APPORTIONED]

[PART 3
RECEIPTS NORMALLY APPORTIONED]

[ARTICLE] 9
ALLOCATION OF DISBURSEMENTS DURING ADMINISTRATION OF TRUST

[ARTICLE] 10
MISCELLANEOUS PROVISIONS

REVISED UNIFORM PRINCIPAL AND INCOME ACT

PREFATORY NOTE

The current revision of the former Uniform Principal and Income Acts, like the 1997 revision, is intended to reflect and address changes in the design and use of trusts. Very long-term trusts are more common, as are total discretionary trusts – that is, trusts in which more income and principal are distributable to beneficiaries during the term of the trust only in the discretion of the trustee. Even where income distributions are mandatory, including occasions where income distributions are mandated by requirements of tax law (such as the estate tax marital deduction), discretion in the trustee to invade supplemental income distributions by invasions of principal are common.

One result of these developments in the design, use, and role of trusts is to make historical distinctions between income and principal less important as a technical matter. Discretionary accumulation of income has the effect of treating income as principal to the extent of the accumulation. And discretionary invasion of principal has the effect of treating principal as income to the extent of the invasion. Even so, the difference between income and principal is important to impartial trustees and beneficiaries alike. If nothing else, the history of distinctions between the tree and its fruit and between the herd and the calf have created a dignity and discipline that are relevant in the administration of even a total discretionary modern trust. Thus, the Drafting Committee has chosen to retain the historical distinctions, including the historical technical rules that have evolved through changing legal and practical environments, while still allowing skilled and dedicated trustees the ability to respond and act appropriately in legal and practical environments that inevitably will continue to change.

The basic premise of the current revision is that a trustee that is aware of the current practical environment of trust administration and sensitive to the evolving demands of impartiality should be able to determine methods of distinguishing between income and principal that are reasonable in the circumstances. Authority to make such determinations, and to update them from time to time, is granted by new Section 301. Authority to make adjustments between income and principal from year to year, introduced as Section 104 in 1997, is retained, and indeed significantly expanded, in new Section 401. The most important way in which the authority to adjust is expanded is by eliminating the precondition that trust distributions are constricted by the concept of "income" in a way that economic results from year to year could arbitrarily affect. In other words, while the trustee of a more modern trust with greater, if not total, flexibility to make distributions from income and/or principal would actually have been *denied* the flexibility intended by former Section 104, new Section 401 would ensure that designing a trust for greater flexibility would not ironically sacrifice the flexibility of adjustment.

That means that the technical structure of the current Act exhibits a certain amount of apparent redundancy. A trustee that can cope with the constraints of income and principal rules by merely accumulating income or invading principal now is given the alternative of actually changing the income and principal rules under Section 301. On top of that, the trustee that still doesn't like the effect of its own rules in any given year can deal with it by accumulating income or invading principal, but is still given the alternative of making an adjustment under Section 401 instead.

This is how the current Act respects, and permits a trustee to respect, the historical dignity and discipline of the simple notion of "income." Under Section 301 a trustee of even a discretionary trust can develop definitions of income and principal that are appropriate to the circumstances of the trust and its beneficiaries and can still make adjustments from year to year under Section 401– a nonexclusive list of factors informing both actions is provided in Section 301(a) – and still achieve the comfortable outcome of "distributing income." And when the needs and rights of beneficiaries under the terms of the trust are still not achievable within the framework of "distributing income" – when no reasonable definition of income or reasonable adjustment would meet those needs, or when significantly non-pro rata distributions are justified – then invasions of principal are still appropriate to the extent consistent with the terms of the trust.

A trustee that prefers not to customize an income and principal policy under Section 301 still has the option of following the more traditional rules, which are retained, with modest updates, in Articles 6 through 9.

As perhaps the "ultimate adjustment," Section 501 adds the authority for a trustee to convert an income trust to a unitrust. This is discussed in the Comment to Section 501.

Finally, Section 105 provides an important clarification that the income and principal act is a statute governing the administration, not construction, of trusts. As such, the statute of the state which is the principal place of administration of the trust from time to time will be the governing law.

1997 Revision

The 1997 revision of the 1931 Uniform Principal and Income Act and the 1962 Revised Uniform Principal and Income Act has two purposes.

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

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

Revision of the 1931 and 1962 Acts

The prior Acts and the 1997 revision of those Acts deal with four questions affecting the rights of beneficiaries:

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

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

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

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

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

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

(1) The application of the probate administration rules to revocable living trusts after the settlor's death and to other terminating trusts. Articles 6 and 7.

(2) The payment of interest or some other amount on the delayed payment of an outright pecuniary gift that is made pursuant to a trust agreement instead of a will when the agreement or state law does not provide for such a payment. Section 601(3).

(3) The allocation of net income from partnership interests acquired by the trustee other than from a decedent (the old Acts deal only with partnership interests acquired from a decedent). Section 801.

(4) 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. Section 803.

(5) The allocation of receipts from discount obligations such as zero-coupon bonds. Section 806(b).

(6) The allocation of net income from harvesting and selling timber between principal and income. Section 812.

(7) The allocation between principal and income of receipts from derivatives, options, and asset-backed securities. Sections 814 and 815.

(8) Disbursements made because of environmental laws. Section 902(a)(7).

(9) Income tax obligations resulting from the ownership of S corporation stock and interests in partnerships. Section 905.

(10) 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. Section 906.

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) 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. Section 703.

(2) Income from a partnership is based on actual distributions from the partnership, in the same manner as corporate distributions. Section 801.

(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. Section 801(d)(2).

(4) Deferred compensation is dealt with in greater detail in a separate section. Section 809.

(5) The 1962 Act rule for "property subject to depletion," (patents, copyrights, royalties, 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. Section 810.

(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. Section 811.

(7) The unproductive property rule has been eliminated for trusts other than marital deduction trusts. Section 813.

(8) Charging depreciation against income is no longer mandatory, and is left to the discretion of the trustee. Section 903.

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) (hereinafter Restatement of

Trusts 3d: Prudent Investor Rule). 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 of Trusts 3d: Prudent Investor Rule; John H. Langbein, The Uniform Prudent Investor Act and the Future of Trust Investing, 81 Iowa L. Rev. 641 (1996); 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 (2d ed. 1998). 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).

REVISED UNIFORM PRINCIPAL AND INCOME ACT

[ARTICLE] 1

DEFINITIONS AND FIDUCIARY DUTIES

SECTION 101. SHORT TITLE. This [Act] may be cited as the Uniform Trust Income and Principal Act. [IF THE COMMITTEE AND THE CONFERENCE AGREE TO THIS NAME CHANGE]

Comment

Name. The change in the name of this Uniform Act has three purposes and effect.

First, this name will distinguish the Act from its 1931, 1962, and 1997 predecessors and support an acronym that will not be confused with the Uniform Prudent Investor Act that was closely associated with its 1997 predecessor.

Second, by using the word "Trust," the name emphasizes that the importance of distinguishing between income and principal is more pressing in the context of arrangements that continue for a long time, perpetually in the case of some modern trusts, and therefore present a greater possibility of competing interests between those entitled to income currently and those who may be entitled to income and/or principal – that is, entitled to "what's left" – after the current interests terminate by death or otherwise. The Act is intended to apply to more than just trusts, notably to decedents' estates. But its application to decedents' estates and other arrangements will arise where those estates and other arrangements share the long-term character and need for balancing of successive interests that is most commonly associated with trusts.

Third, placing income first in the name emphasizes this fact that principal may be "what's left" after income is paid out. After income is paid out it is gone and normally cannot be retrieved (although prior over-distributions can sometimes be taken into account in determining the amount of future distributions). This in turn highlights the bias toward principal that for practical reasons has appeared in previous version of the Act and is made even more explicit in this version.

SECTION 102. DEFINITIONS. In this [Act]:

(1) "Accounting period" means a calendar year unless another period of 12 calendar months or approximately 12 calendar months is selected by a trustee. The term includes a part 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 trust, an income beneficiary, including a current income beneficiary, a remainder beneficiary, and any other successor beneficiary, and, in the case of a decedent's estate, an heir[, legatee,] and devisee.

(3) "Current income beneficiary" means a person to which net income of a trust is or may be payable, whether principal may also be distributed to that person.

(4) "Income" means money or property a trustee receives as current return from a principal asset. The term includes a part of receipts from a sale, exchange, or liquidation of a principal asset, to the extent provided in [Article] 8.

(5) "Income interest" means the right of a current income beneficiary to receive all or part of net income, whether the terms of the trust require it to be distributed or authorize it to be distributed in the trustee's discretion.

(6) "Mandatory income interest" means the right of a current income beneficiary to receive net income that the terms of the trust require the trustee to distribute.

(7) "Net income" means the total receipts allocated to income during an accounting period minus the disbursements made from income during the period, plus or minus transfers under this [act] to or from income during the period.

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

(9) "Principal" means property held in trust for distribution to, production of income for, or use by a successor beneficiary, unless it is distributed to the current income beneficiary the terms of the trust, this [act], or other applicable law.

(10) "Record" means information that is inscribed on a tangible medium or that is stored

in an electronic or other medium and is retrievable in perceivable form.

(11) "Successor beneficiary" means a person entitled to receive income or principal when an income interest ends.

(12) "Terms of the 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. In cases where a "trust" includes a decedent's estate, "terms of the trust" include the decedent's will.

(13) "Trust" includes a decedent's estate, life estate, guardianship or conservatorship, or other arrangement or relationship to the extent a person holds possession of property for the benefit of persons that may succeed to an interest in the property, if the interests of those successor persons may be affected by the allocation of receipts and expenditures between income and principal.

(14) "Trustee" includes an original, additional, or successor trustee, whether or not appointed or confirmed by a court. "Trustee" also includes an executor, administrator, or personal representative of a decedent's estate, life tenant, guardian or conservator or other person that holds possession of property for the benefit of persons that may succeed to an interest in the property, if the interests of those successor persons may be affected by the allocation of receipts and expenditures between income and principal, whether the trustee also has a beneficial interest in the property.

Comment

"Accounting period." The change will clarify that a 52-53-week fiscal year, contemplated by section 441(f) of the Internal Revenue Code, or any other reasonable fiscal year, is not precluded.

"Income beneficiary." The definitions of current income beneficiary (Section 102(3)) 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 underproductive property provision) or changed in a way that eliminates the need for the term (in the case of bonds and other money obligations, property subject to depletion, and the method for determining entitlement to income distributed from a probate estate).

"Net income." The reference to "transfers under this Act to or from income" means transfers made under Sections 401(a), 812(b), 902(b), 903(b), 904(a), and 906.

"Record." This addition in the current Act is copied from Section 2(22) of the Uniform Trust Decanting Act.

"Successor beneficiary." This term is used in the current Act rather than "remainder beneficiary," the term in the 1997 Act, in recognition of the fact that trusts often last longer than the life of a single income beneficiary, and therefore the beneficiaries whose future interests are most often in need of balance and protection are beneficiaries who continue as income beneficiaries, not who succeed to the "remainder" interest as if the trust terminates. The term "successor beneficiary" includes "remainder beneficiaries."

"Terms of the trust." The term "Terms of a trust" was chosen in the 1997 Act in preference to "terms of the trust instrument" (the phrase used in the 1962 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. The phrase is changed to "terms of the trust" in the current Act because in context that phrase is used much more often in the text of the Act.

SECTION 103. FIDUCIARY DUTIES; GENERAL PRINCIPLES.

(a) In allocating receipts and disbursements to or between income and principal, and with respect to any matter within the scope of [Articles] 6 and 7, a trustee:

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

(2) may administer a trust by the exercise of a discretionary power of administration given to the trustee by the terms of the trust, even if the exercise of the power

produces a result different from a result required or permitted by this [act];

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

(4) shall add a receipt to principal to the extent the terms of the trust and this [act] do not provide a rule for allocating the receipt to or between income and principal; and

(5) shall charge a disbursement to income to the extent the terms of the trust and this [act] do not provide a rule for allocating the disbursement to or between income and principal.

(b) In exercising the power to adjust under Section 401(a) or a discretionary power of administration regarding a matter within the scope of this [act], whether granted by the terms of the trust or this [act], a trustee shall administer a trust impartially, based on what is fair and reasonable to all the beneficiaries, giving due regard to the beneficiaries' respective interests and relationships to each other, except to the extent the terms of the trust clearly manifest an intention that the trustee 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 the beneficiaries.

Comment

No negative inference is intended if the trustee departs from the standards explicitly provided in the Act.

Subsection (a)(5) is added, and subsection (a)(4) is changed, to favor principal (an arguable purpose of the original subsection (a)(4)) with respect to both receipts and disbursements. See also Section 901(2).

There are more ways to preserve and encourage impartiality than determining what is income and what is principal. Examples include making investments prudently, making distribution decisions thoughtfully, and explaining these actions transparently.

The terms of the trust may alter the degree or nature of impartiality without abandoning the duty of impartiality. For example, the terms of the trust may permit or require a current beneficiary to be preferred to meet needs for support in accordance with an accustomed standard of living and for medical care, but in making determinations regarding that standard the trustee owes a duty of impartiality to the current beneficiary and the successive beneficiaries. If such a preference for support and health is expressed, this law preserves the duty of impartiality in making discretionary distributions when that standard is satisfied.

The phrase "giving due regard to the beneficiaries' respective interests" is copied from Section 803 of the Uniform Trust Code, relating to impartiality. The addition of the phrase "and relationships to each other" could be relevant, for example, where the trustee takes note of the fact that the successor beneficiaries following a life income interest of the settlor's surviving spouse are descendants of that spouse, or not descendants of that spouse, or some who are the spouse's descendants and some who are not.

Drafting Note: *When the Uniform Directed Trust Act is completed, this section should be reviewed to ensure that it appropriately authorizes delegation to a co-trustee, special trustee, protector, committee, accountant, or the like, particularly in light of how the Uniform Directed Trust Act deals with section 2041(b)(1)(C) of the Internal Revenue Code.*

Comment to 1997 Act

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) of the 1962 Act 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) states that it also applies to matters within the scope of Articles 6 and 7. 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 do not 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 Comment *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 after this Act was approved by the Commissioners on Uniform State Laws) or because a transaction is of a type or occurs in a manner not anticipated by the Drafting Committee for this Act or the drafter of the trust instrument. (Section 816, relating to other financial instruments and arrangements, is added to the current Act to provide guidance for such financial instruments and arrangements designed in the future, which the Drafting Committee could not have anticipated and addressed explicitly.)

Allocating to principal a disbursement for which there is no provision in the Act or the terms of the trust preserves the current income beneficiary's level of income in the year it is allocated to principal, but thereafter will reduce the amount of income produced by the principal. Allocating to principal a receipt for which there is no provision will increase the income received by the current 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. However, if the trustee decides that an adjustment between principal and income is needed to enable the trustee to comply with Section 103(b), after considering the return from the portfolio as a whole, the trustee may make an appropriate adjustment under Section 401(a).

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

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

SECTION 104. JUDICIAL REVIEW OF DISCRETIONARY POWER.

(a) The court may not order a trustee to change a decision to exercise or not to exercise a discretionary power conferred by this [act] unless it determines that the decision was an abuse of the trustee's discretion. A trustee's decision is not an abuse of discretion merely because the court would have exercised the power in a different manner or would not have exercised the power.

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

Legislative Note: *Modify this provision if your state does not permit what in effect are declaratory judgments in such matters.*

Comment to 1997 Act

General. All of the discretionary powers in the 1997 Act are subject to the normal rules that govern a fiduciary's exercise of discretion. Section 104 codifies those rules for purposes of the Act so that they will be readily apparent and accessible to fiduciaries, beneficiaries, their counsel and the courts if and when questions concerning such powers arise. This may be useful, for example, even in a state that has enacted the Uniform Trust Code, which provides for comparable duties and remedies.

Section 104 also makes clear that the normal rules governing the exercise of a fiduciary's powers apply to the discretionary power to adjust conferred upon a trustee by Section 104(a). Discretionary provisions authorizing trustees to determine what is income and what is principal have been used in governing instruments for years; Section 2 of the 1931 Uniform Principal and Income Act recognized that practice by providing that "the person establishing the principal may himself direct the manner of ascertainment of income and principal...or grant discretion to the trustee or other person to do so....” Section 103(a)(2) also recognizes the power of a settlor to grant such discretion to the trustee. Section 104 applies to a discretionary power granted by a will or the terms of the trust as well as the power to adjust in Section 401(a).

Power to Adjust. The exercise of the power to adjust is governed by a trustee’s duty of impartiality, which requires the trustee to strike an appropriate balance between the interests of the income and remainder beneficiaries. Section 103(b) expresses this duty by requiring the trustee to “administer a trust or estate impartially, based on what is fair and reasonable to all of the beneficiaries, except to the extent that 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.” Because this involves the exercise of judgment in circumstances rarely capable of perfect resolution, trustees are not expected to achieve perfection; they are, however, required to make conscious decisions in good faith and with proper motives.

In seeking the proper balance between the interests of the beneficiaries in matters involving principal and income, a trustee’s traditional approach has been to determine the settlor’s objectives from the terms of the trust, gather the information needed to ascertain the financial circumstances of the beneficiaries, determine the extent to which the settlor’s objectives can be achieved with the resources available in the trust, and then allocate the trust’s assets between stocks and fixed-income securities in a way that will produce a particular level or range of income for the current income beneficiary. The key element in this process has been to determine the appropriate level or range of income for the current income beneficiary, and that will continue to be the key element in deciding whether and to what extent to exercise the discretionary power conferred by Section 401(a). If it becomes necessary for a court to determine whether an abuse of the discretionary power to adjust between principal and income has occurred, the criteria should be the same as those that courts have used in the past to determine whether a trustee has abused its discretion in allocating the trust’s assets between stocks and fixed-income securities.

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

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

While a trustee must consider the portfolio as a whole in deciding whether and to what extent to exercise the power to adjust, a trustee may apply different criteria in considering the portion of the portfolio that is composed of marketable securities and the portion whose market value cannot be determined readily, and may take into account a beneficiary's use or possession of a trust asset.

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

General rule. The first sentence of Section 104(a) is from Restatement (Second) of Trusts § 187 and Restatement (Third) of Trusts (Tentative Draft No. 2, 1999) § 50(1). The second sentence of Section 104(a) derives from Comment *e* to § 187 of the Second Restatement and Comment *b* to § 50 of the Third Restatement.

The reference in Section 104(a) to a trustee's decision to exercise or not to exercise a discretionary power underscores a fundamental precept, which is that a trustee has a duty to make a conscious decision about exercising or not exercising a discretionary power. Comment *b* to § 50 of the Third Restatement states:

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

Section 104(b) makes clear that the rule of subsection (a) applies not only to the power conferred by Section 401(a) but also to the evaluation process required by Section 401(b) in deciding whether and to what extent to exercise the power to adjust. Under Sections 401(b), a trustee is to consider all of the factors that are relevant to the trust and its beneficiaries, including, to the extent the trustee determines they are relevant, the 13 factors enumerated in Section 301(e). Section 301(e) derives from Section 2(c) of the Uniform Prudent Investor Act, which lists eight circumstances that a trustee shall consider, to the extent they are relevant, in investing and managing assets. The trustee's decisions about what factors are relevant for purposes of Section 104(b) and the weight to be accorded each of the relevant factors are part of the discretionary decision-making process. As such, these decisions are not subject to change for the purpose of changing the trustee's ultimate decision unless the court determines that there has been an abuse of discretion in determining the relevancy and weight of these factors.

Remedy. The exercise or nonexercise of a discretionary power under the Act normally affects the amount or timing of a distribution to the income or remainder beneficiaries. The primary remedy under Section 104(c) for abuse of discretion is the restoration of the beneficiaries and the trust to the positions they would have occupied if the abuse had not occurred. It draws on a basic principle of restitution that if a person pays money to someone who is not intended to receive it (and in a case to which this Act applies, not intended by the settlor to receive it in the absence of an abuse of discretion by the trustee), that person is entitled to restitution on the ground that the payee would be unjustly enriched if he were permitted to retain the payment. See Restatement of Restitution § 22 (1937). The objective is to accomplish the restoration initially by making adjustments between the beneficiaries and the trust to the extent possible; to the extent that restoration is not possible by such adjustments, a court may order the trustee to pay an amount to one or more of the beneficiaries, the trust, or both the beneficiaries and the trust. If the court determines that it is not possible in the circumstances to restore them to their appropriate positions, the court may provide other remedies appropriate to the circumstances. The approach of Section 104(c) is supported by Comment *b* to § 50 of the Third Restatement of Trusts:

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

Advance determinations. Section 104(d) employs the familiar remedy of the trustee's petition to the court for instructions. It requires the court to determine, upon a petition by the trustee, whether a proposed exercise or nonexercise of a discretionary power by the trustee of a power conferred by the Act would be an abuse of discretion under the general rule of Section 104(a). If the petition contains the information prescribed in the second sentence of subsection (d), the proposed action or inaction is presumed not to result in an abuse, and a beneficiary who challenges the proposal must establish that it will.

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

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

> (a) the beneficiary was under an incapacity at the time of such consent or of such act or omission; or
>
> (b) the beneficiary, when he gave his consent, did not know of his rights and of the material facts which the trustee knew or should have known and which the trustee did not reasonably believe that the beneficiary knew; or
>
> (c) the consent of the beneficiary was induced by improper conduct of the trustee.

Restatement (Second) of Trusts § 216.

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

SECTION 105. GOVERNING LAW. This [act] contains rules governing the administration of trusts within its scope, not rules of construction. This [act] applies when this State is the principal place of administration of the trust. By accepting the trusteeship of a trust having its principal place of administration in this State or by moving the principal place of administration to this State, the trustee submits to the application of this [act] to any matter within its scope involving the trust.

Comment

Rule of Administration. A "rule of construction" is typically governed by the law of the place where the trust was created or deemed created. A "rule of administration" is typically governed by the law of the situs of the trust from time to time, with appropriate savings provisions for tax benefits, etc. if the situs is changed. Authorities are divided on which historical category includes an income and principal act. *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 268, Comment h (1971):

> The question of the allocation of receipts and expenditures to principal or income presents a different problem. See Restatement of Trusts (Second), §§ 232-241. If a testator creates a trust to be administered in a state other than that of his domicil, the question is whether the allocation, as for instance of extraordinary dividends, is to be determined by the local law of his domicil or the local law of the place of administration.

> This could conceivably be treated as a question of administration and governed by the local law of the place of administration. On the other hand, it can be treated as a question of the distribution of the trust property and governed by the local law of the testator's domicil. For the purposes of the choice of the applicable law, it is generally held that it is a question of construction and that the local law of the testator's domicil is applicable.

Despite this division of authority, treating income and principal allocations as rules of administration seems to be the most workable approach and seems to be contemplated, for example, by the change-of-situs examples in the 2003 amendments to the GST tax regulations (Reg. § 26.2601-1(b)(4)(i)(E), Examples 11 & 12). Perhaps the biggest burden of a rule of construction is determining the governing law not only *where* the trust was originally created but also *when* the trust was originally created, a burden that gets greater as longer-term trusts become more common and existing trusts therefore become older. Section 105 clarifies that the Uniform Trust Income and Principal Act is a rule of administration, and the situs, or principal place of administration, of the trust determines the law that governs.

[ARTICLE] 2

DETERMINATION OF INCOME AND PRINCIPAL

SECTION 201. DETERMINATION OF INCOME AND PRINCIPAL.

(a) By adopting a policy under Section 301, a trustee may determine a method of allocating receipts and disbursements between income and principal that serves the interests of the trust and the beneficiaries.

(b) A trustee that does not adopt a policy under Section 301 must allocate receipts and disbursements between income and principal under [Articles] 6 through 9, subject to Sections 401 and 501.

(c) A trustee may adjust between income and principal under Section 401, regardless of whether the trustee has adopted a policy under Section 301 or is allocating receipts and disbursements between income and principal under [Articles] 6 through 9.

(d) A trustee may convert an income trust to a unitrust, convert a unitrust to an income trust, or change the percentage or method used to calculate the unitrust amount under Section 501, regardless of whether

(1) the trustee has adopted a policy under Section 301 or is allocating receipts and disbursements between income and principal under [Articles] 6 through 9 or

(2) the trustee has ever adjusted between income and principal under Section 401.

Comment

This "overview" of the new Uniform Trust Income and Principal Act embraces and confirms the core principle and intention of the new Act that a trustee, subject to fiduciary duties and standards, may adopt a policy for allocating trust receipts and disbursements between income and principal that the trustee determines to be in the best interests of the trust and its beneficiaries. To the extent a trustee chooses not to do that, the income and principal allocations of the trust are governed by Articles 6 through 9 of this Act, which are modeled after Articles 2 through 5 of the 1997 Revised Uniform Principal and Income Act.

This overview also confirms the continued availability of the "power to adjust" that has proven to be a successful addition to the 1997 Act and the availability of the power to convert to a unitrust that was notably deferred when the 1997 Act was written and has been one of the foremost additions anticipated in this Act.

Finally, this overview confirms, as the referenced provisions of the Act themselves make clear, that these available measures are not mutually exclusive, but may be employed in any combinations and measures that best serve the interests of the trust and its beneficiaries.

[ARTICLE] 3

POWER TO ALLOCATE RECEIPTS AND DISBURSEMENTS BETWEEN INCOME AND PRINCIPAL

SECTION 301. TRUSTEE'S POWER TO ALLOCATE RECEIPTS AND DISBURSEMENTS BETWEEN INCOME AND PRINCIPAL.

(a) A trustee may, without court approval, adopt a policy in a record for the trust providing

(1) receipts and disbursements that must be allocated to income,

(2) receipts and disbursements that must be allocated to principal,

(3) receipts and disbursements that must be allocated part to income and part to principal and the method of the allocation, and

(4) the method of determining the allocation between income and principal of receipts and disbursements to the extent the allocation is not covered under paragraphs (1), (2), and (3).

(b) A trustee may, without court approval, make changes in a record to a policy adopted under subsection (a).

(c) This section does not create or imply a duty to adopt a policy under subsection (a) or to inform beneficiaries about the applicability of this section.

(d) To the extent a trustee has not addressed the allocation of receipts and disbursements between income and principal in a policy adopted under subsection (a), the allocation must be determined under [Articles] 6 through 9 of this [act], subject to Sections 401 and 501.

(e) In deciding whether and to what extent to exercise the power conferred by subsection (a), a trustee shall consider the need for the preservation and appreciation of the capital of the trust, including the reasonable maintenance of the value of capital measured by cost of living and other indices the trustee determines to be appropriate, and shall consider all other factors relevant to the trust and its beneficiaries, including the following factors to the extent they are relevant:

(1) the terms of the trust;

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

(3) the intent of the settlor;

(4) the identity and circumstances of the beneficiaries;

(5) the needs of the trust and the beneficiaries for liquidity and regularity of income;

(6) the role of allocations between income and principal in enabling the trustee to comply with Section 103(b) after applying the rules in Section 103(a);

(7) 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, real property, or assets for which specialized treatment is provided in [Articles] 6 through 9 of this [act]; the extent to which an asset is used or may be used by a beneficiary; and whether an asset was purchased by the trustee or received from the settlor;

(8) the net amount that would be allocated to income under [Articles] 6 through 9 of this [act] to the extent they apply;

(9) 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;

(10) 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;

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

(12) the anticipated tax consequences of a policy under subsection (a).

(f) A trustee may not adopt a policy under subsection (a) or make a change to a policy under subsection (b):

(1) that diminishes the income interest in a trust that requires all the income to be paid at least annually to a 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 assets;

(4) that reduces any amount that is permanently set aside for charitable purposes under the terms of the trust unless both income and principal are so set aside;

(5) if possessing or exercising the power to adopt or change the policy causes 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 trustee 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 value of the trust assets to be included for estate tax purposes in the gross estate of an individual who has the power to remove a trustee or appoint a trustee, or both, and the value of the assets would not be included in the gross estate of the individual if the trustee did not possess the power to make an adjustment;

(7) if the trustee is a beneficiary of the trust whose interest would be materially affected by the action; or

(8) if the adoption or change of the policy would benefit the trustee directly or indirectly.

(g) If subsection (f)(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 take the action unless taking the action by the remaining trustee or trustees is not permitted by the terms of the trust.

(h) Terms of the trust that limit the power of a trustee to adopt a policy under subsection (a) or make a change to a policy under subsection (b) do not affect the application of this section unless it is clear from the terms of the trust that the terms are intended to deny the trustee the powers conferred by subsections (a) and (b).

(i) A trustee's adoption of a policy under subsection (a) and changes to that policy under subsection (b) must be included in the report that is sent to beneficiaries under [Section 813(c)] of [the Uniform Trust Code].

(j) A trustee that in good faith takes or fails to take any action under this section is not liable to a person affected by the action or inaction. The exclusive remedy of a person affected by a trustee's good-faith action or inaction under this section is to obtain a court order directing the trustee to change or abandon a policy adopted under subsection (a).

Comment

Factors. The factors in Section 301(e) that a trustee should consider are adapted from Section 104(b) of the 1997 Act, which were written in the context of the power to adjust now found in Section 401. Priority is given to "reasonable maintenance of the value of capital measured by cost of living and other indices the trustee determines to be appropriate." While the Drafting Committee considered preservation of capital to be important and affirmed that in other biases in favor of principal elsewhere in the Act, the committee did not intend that this preference be an impossible burden and intended that it be implemented in a reasonable way. An expectation of consistently "matching" or "beating" inflation indices would not be reasonable. But in an environment of more widespread use of long-term trusts, the committee believed that a trustee should at least take note of the direction and extent of changes in the cost of living in establishing both aspirational targets and practical metrics for the trust.

Former Section 104(b)(5), now Section 301(e)(7), includes "whether an asset was purchased by the trustee or received from the settlor" as a factor to consider. This acknowledges the special status historically accorded to "inception assets" that are contributed to the trust by the settlor as part of the initial funding, not acquired by the trustee as an investment or reinvestment. The settlor's decision to place an inception asset in trust is a tangible expression of the settlor's intent that deserves some weight, as appropriate. It deserve more weight, of course, to the extent the terms of the trust explicitly refer to inception assets and encourage or require their holding or exonerate the trustee from continuing in good faith to hold them.

Limitations on the exercise of this authority. Section 301(f) prohibits a trustee from exercising this authority to establish an income and principal policy, particularly where certain tax advantages might be jeopardized or the trustee might be personally affected. In the latter case, the Drafting Committee does not intend that a trustee be disqualified merely because of a remote interest in the principal of the trust – for example, if the trustee is a remote contingent beneficiary in the unlikely event a number of younger-generation beneficiaries all die before the termination of the trust. Section 307(f)(7) uses the word "materially" for that reason.

Section 301(g) provides that if a trustee is prohibited from exercising this authority because of the trustee's personal connection to the trust, a co-trustee that is not so limited may exercise the authority. Where there are two or more qualified co-trustees, whether they must act unanimously or by majority vote or in some other way is left to general rules of trust law or the particular governing instrument. But Section 301 does not provide for the appointment of a disinterested person to exercise the authority if no trustee is eligible, as Section 501(k) does, for example, in the case of converting the trust to a unitrust. Unlike a one-time conversion to a unitrust, the development and implementation of an income and principal policy requires ongoing awareness of and attention to the particular characteristics of the trust and its beneficiaries, and the trustee or co-trustee responsible for the policy is in the best position to do that.

Even in a case where Section 301(f) does not prohibit a trustee from establishing an income and principal policy because certain tax advantages might be jeopardized, the trustee's establishment of a policy does not necessarily determine or affect the amount of income that will be subject to federal income tax. Income for federal tax purposes is different from income for purposes of trust administration. As Treasury Reg. §1.643(b)-1 warns, "[t]rust provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized."

[ARTICLE] 4

POWER TO ADJUST

SECTION 401. TRUSTEE'S POWER TO ADJUST.

(a) A trustee may adjust between income and principal to the extent the trustee considers it to be in the best interests of the trust and its beneficiaries. A trustee may adjust between income and principal under this section, regardless of whether the trustee has adopted a policy under Section 301 or is allocating receipts and disbursements between income and principal under [Articles] 6 through 9.

(b) In deciding whether and to what extent to exercise the power conferred by subsection (a), a trustee shall consider all factors relevant to the trust and its beneficiaries, including the factors in Section 301(e) to the extent they are relevant.

(c) A trustee may not make an adjustment:

(1) that diminishes the income interest in a trust that requires all the income to be paid at least annually to a 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 assets;

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

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

(7) if the trustee is a beneficiary of the trust whose interest would be materially affected by the adjustment; or

(8) if 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 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 (c)(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 the trust that limit the power of a trustee to make an adjustment between income and principal do not affect the application of 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).

(g) A trustee's exercise of the power under subsection (a) must be included in the report that is sent to beneficiaries under [Section 813(c)] of [the Uniform Trust Code].

(h) This section does not create or imply a duty to adjust under subsection (a) or to inform beneficiaries about the applicability of this section.

(i) A trustee that in good faith takes or fails to take any action under this section is not liable to a person affected by the action or inaction. The exclusive remedy of a person affected by a trustee's good-faith action or inaction under this section is to obtain a court order directing the trustee to exercise or refrain from exercising the power under subsection (a).

Comment

Limitations on the power to adjust. Like Section 301(f), Section 401(c) prohibits a trustee from exercising the power to adjust where certain tax advantages might be jeopardized or the trustee might be personally affected. In the latter case, again like Section 301(f) the Drafting Committee does not intend that a trustee be disqualified merely because of a remote interest in the principal of the trust – for example, if the trustee is a remote contingent beneficiary in the unlikely event a number of younger-generation beneficiaries all predecease the termination of the trust. Section 401(c)(7) uses the word "materially" for that reason.

Like Section 301, Section 401 does not provide for the appointment of a disinterested person to power to adjust if no trustee is eligible, as Section 501(k) does in the case of converting the trust to a unitrust, for example. Unlike a one-time conversion to a unitrust and like the development and implementation of an income and principal policy, the adjustment between income and principal requires ongoing awareness of and attention to the particular characteristics of the trust and its beneficiaries.

In any event, Section 401(d) allows an adjustment to be made by a qualified co-trustee or co-trustees when the other co-trustee or co-trustees is or are disqualified. As in the case of Section 301(g), whether two or more qualified co-trustees must act unanimously or by majority vote or in some other way is left to general rules of trust law or the particular governing instrument.

Comment to 1997 Act

Purpose and Scope of Provision. The purpose of former Section 104, currently Section 401, is to enable a trustee to select investments using 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, dividends, and rents. In the 1997 version of the Act, Section 401(a) originally authorized a trustee to make adjustments 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 current income beneficiary's distribution rights in terms of the right to receive "income" in the sense of traditional trust accounting income; and (3) the trustee must determine, after applying the rules in Section 103(a), that the trustee is unable to comply with Section 103(b). In deciding whether and to what extent to exercise the power to adjust, the trustee is required to consider the factors described in Section 301(e), but the trustee may not make an adjustment in circumstances described in Section 401(c).

The current version of the Act eliminates the three preconditions from Section 401(a). The precondition of investing as a prudent investor is a common requirement of trust administration. The precondition of expressing a current income beneficiary's distribution rights in terms of traditional trust accounting income has had the effect of limiting the power to adjust to "old-fashioned" trusts requiring mandatory income distributions and prohibiting invasions of principal. The power to adjust is an element of flexibility, and it is unseemly to deny it in the context of the modern trust specifically designed in large part to provide more flexibility. Both expressing a current income beneficiary's distribution rights in terms of traditional trust accounting income and inability or difficulty to impartially comply with fiduciary duties under Section 103(b) are retained as factors to consider, not absolute preconditions, in Section 301(e)(6) and (10).

Section 401 does not empower a trustee to increase or decrease 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 between principal and income that may be necessary if the income component of a portfolio's total return is too small or too large because of investment decisions made by the trustee under the prudent investor rule. The paramount consideration in applying Section 401(a) is the requirement in Section 103(b) that "a trustee shall administer a trust impartially, based on what is fair and reasonable to all of the beneficiaries, giving due regard to the beneficiaries' respective interests and relationships to each other, except to the extent that the terms of the trust or the will clearly manifest an intention that the trustee shall or may favor one or more of the 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, Comment *p* (1959).

Section 401 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 of Trusts 3d: Prudent Investor Rule. Wills and trust instruments executed after the rule is adopted can be drafted to describe a beneficiary's distribution rights in terms that do not depend upon the amount of trust accounting income, but to the extent that drafters of trust documents continue to describe a current income beneficiary's distribution rights by referring to trust accounting income, Section 401 will be an important tool in trust administration.

Impartiality and productivity of income. The duty of impartiality between income and remainder beneficiaries is linked to the trustee's duty to make the portfolio productive of trust accounting income whenever the distribution requirements are expressed in terms of distributing the trust's "income." The 1962 Act implies that the duty to produce income applies on an asset by asset basis because the right of a current income beneficiary to receive "delayed income" from the sale proceeds of underproductive property under Section 12 of that Act arises if "any part of principal ... has not produced an average net income of at least 1% per year of its inventory value for more than a year ... ." Under the prudent investor rule, "[t]o whatever extent a requirement of income productivity exists, ... the requirement applies not investment by investment but to the portfolio as a whole." Restatement of Trusts 3d: Prudent Investor Rule § 227, Comment *i*, at 34. The power to adjust under Section 401(a) is also to be exercised by considering net income from the portfolio as a whole and not investment by investment. Section 813(b) of this Act eliminates the underproductive property rule in all cases other than trusts for which a marital deduction is allowed; the rule applies to a marital deduction trust if the trust's assets "consist substantially of property that does not provide the spouse with sufficient income from or use of the trust assets ..." – in other words, the section applies by reference to the portfolio as a whole.

While the purpose of the power to adjust in Section 401(a) is to eliminate the need for a trustee who operates under the prudent investor rule to be concerned about the income component of the portfolio's total return, the trustee must still determine the extent to which a distribution must be made to a current income beneficiary and the adequacy of the portfolio's liquidity as a whole to make that distribution.

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

Factors to consider in exercising the power to adjust. Section 401(b) requires a trustee to consider factors relevant to the trust and its beneficiaries in deciding whether and to what extent the power to adjust should be exercised. Section 2(c) of the Uniform Prudent Investor Act sets forth circumstances that a trustee is to consider in investing and managing trust assets. The circumstances in Section 2(c) of the Uniform Prudent Investor Act are the source of the factors in paragraphs (4), (5), (7), (8), and (11) of Section 301(e) (modified where necessary to adapt them to the purposes of this Act) so that, to the extent possible, comparable factors will apply to investment decisions and decisions involving the power to adjust. If a trustee who is operating under the prudent investor rule decides that the portfolio should be composed of financial assets whose total return will result primarily from capital appreciation rather than dividends, interest, and rents, the trustee can decide at the same time the extent to which an adjustment from principal to income may be necessary under Section 401. On the other hand, if a trustee 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 current income beneficiary with the beneficial interest to which the beneficiary is entitled under the terms of the trust, the trustee can decide that it is unnecessary to exercise the power to adjust.

Assets received from the settlor. Section 3 of the Uniform Prudent Investor Act provides that "[a] trustee shall diversify the investments of the trust unless 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, the trustee may 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. See Section 104(b)(5); Uniform Prudent Investor Act § 3, Comment, 7B U.L.A. 18, at 25-26 (Supp. 1997); Restatement of Trusts 3d: Prudent Investor Rule § 229 and Comments *a-e.*

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

Under subsection (c)(1), a trustee cannot make an adjustment that diminishes the income interest in a trust that requires all of the income to be paid at least annually to a spouse and 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 spouse. Subsection (c)(1) applies to a trust that qualifies for the marital deduction because the spouse has a general power of appointment over the trust, but it applies to a qualified terminable interest property (QTIP) trust only if and to the extent that the fiduciary makes the election required to obtain the tax deduction. Subsection (c)(1) does not apply to a so-called "estate" trust. This type of trust qualifies for the marital deduction because the terms of the trust require the principal and undistributed income to be paid to the surviving spouse's estate when the spouse dies; it is not necessary for the terms of an estate trust to require the income to be distributed annually. 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 a fixed annuity or a fixed fraction of the value of a trust's assets is not subject to adjustment under Section 401(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 401(a) in determining the amount of the trust's income.

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

Release of the power to adjust. Section 401(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 current 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. Section 401(f) applies to trust provisions that limit a trustee's power to adjust. Since the power is intended to enable trustees to employ the prudent investor rule without being constrained by traditional principal and income rules, an instrument executed before the adoption of this Act whose terms describe the amount that may or must be distributed to a beneficiary by referring to the trust's income or that prohibit the invasion of principal or that prohibit equitable adjustments in general should not be construed as forbidding the use of the power to adjust under Section 401(a) if the need for adjustment arises because the trustee is operating under the prudent investor rule. Instruments containing such provisions that are executed after the adoption of this Act should specifically refer to the power to adjust if the settlor intends 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).

Examples. The following examples illustrate the application of Section 401:

Example (1) – T is the successor trustee of a trust that provides income to A for life, remainder to B. T has received from the prior trustee a portfolio of financial assets invested 20% in stocks and 80% in bonds. Following the prudent investor rule, T determines that a strategy of investing the portfolio 50% in stocks and 50% in bonds has risk and return objectives that are reasonably suited to the trust, but T also determines that adopting this approach will cause the trust to receive a smaller amount of dividend and interest income. After considering the factors in Section 301(e), T may transfer cash from principal to income to the extent T considers it necessary to increase the amount distributed to the current income beneficiary.

Example (2) – T is the trustee of a trust that requires the income to be paid to the settlor's son C for 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 Section 806 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 part of the interest to principal.

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. E's income from her social security, pension, and savings exceeds the amount required to provide for her accustomed standard of living. 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. Applying the prudent investor rule, T determines that the trust assets should be invested entirely in growth stocks that produce very little 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 current income beneficiary of a trust, and T may transfer cash from principal to income to provide her with that degree of enjoyment.

Example (4) – T is the trustee of a trust that is governed by the law of 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, and also give T the power to invade principal for the benefit of G for "dire emergencies only." The terms of the trust limit the aggregate amount that T can distribute to G from principal during G's life to 6% of the trust's value at its inception. The trust's portfolio is invested initially 50% in stocks and 50% in bonds, but after State X adopts the prudent investor rule T determines that, to achieve suitable risk and return objectives for the trust, the assets should be invested 90% in stocks and 10% in bonds. This change increases the total return from the portfolio and decreases the dividend and interest income. Thereafter, even though G does not experience a dire emergency, T may exercise the power to adjust under Section 401(a) to the extent that T determines that the adjustment is from only the 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 for the settlor's child. The trust owns a diversified portfolio of marketable financial assets with a value of $600,000, and is also the sole beneficiary of the settlor's IRA, which holds a diversified portfolio of marketable financial assets with a value of $900,000. The trust receives a distribution from the IRA that is the minimum amount required to be distributed under the Internal Revenue Code, and T allocates 10% of the distribution to income under Section 809(c) of this Act. The total return on the IRA's assets exceeds the amount distributed to the trust, and the value of the IRA at the end of the year is more than its value at the beginning of the year. Relevant factors that T may consider in determining whether to exercise the power to adjust and the extent to which an adjustment should be made to comply with Section 103(b) include the total return from all of the trust's assets, those owned directly as well as its interest in the IRA, the extent to which the trust will be subject to income tax on the portion of the IRA distribution that is allocated to principal, and the extent to which the current income beneficiary will be subject to income tax on the amount that T distributes to the current income beneficiary.

Example (6) – T is the trustee of a trust whose portfolio includes a large parcel of undeveloped real estate. T pays real property taxes on the undeveloped parcel from income each year pursuant to Section 901(3). After considering the return from the trust's portfolio as a whole and other relevant factors described in Section 301(e), T may exercise the power to adjust under Section 401(a) to transfer cash from principal to income in order to distribute to the current income beneficiary an amount that T considers necessary to comply with Section 103(b).

Example (7) – T is the trustee of a trust whose portfolio includes an interest in a mutual fund that is sponsored by T. As the manager of the mutual fund, T charges the fund a management fee that reduces the amount available to distribute to the trust by $2,000. If the fee had been paid directly by the trust, one-half of the fee would have been paid from income under Section 901(1) and the other one-half would have been paid from principal under Section 902(a)(1). After considering the total return from the portfolio as a whole and other relevant factors described in Section 301(e), T may exercise its power to adjust under Section 401(a) by transferring $1,000, or half of the trust's proportionate share of the fee, from principal to income.

[ARTICLE] 5

UNITRUST

SECTION 501. UNITRUST.

(a) In this section:

(1) "Disinterested person" means a person who is not a "related or subordinate party," as that term is defined in Section 672(c) of the Internal Revenue Code of 1986[, as amended][, 26 U.S.C. Section 672(c)][, as amended] with respect to a beneficiary of the trust. "Disinterested person" does not include the settlor of the trust or the spouse of the settlor of the trust.

(2) "Income trust" means a trust that is not a unitrust, regardless of the terms of the trust concerning distributions.

(3) "Net fair market value of the trust" means the fair market value of the assets of the trust, less the liabilities of the trust.

(4) "Tax benefit" means:

(A) eligibility of a transfer to a trust for the exclusion from gifts described in Section 2503(b) of the Internal Revenue Code of 1986[, as amended][, 26 U.S.C. Section 2503(b)][, as amended] by reason of the qualification of an income interest in the trust as a present interest;

(B) qualification of a trust as a qualified subchapter S trust described in Section 1361(d) of the Internal Revenue Code of 1986[, as amended][, 26 U.S.C. Section 1361(d)][, as amended] at a time the trust holds stock of an S corporation defined in Section 1361(a)(1) of the Internal Revenue Code of 1986[, as amended][, 26 U.S.C. Section 1361(a)(1)][, as amended];

(C) qualification of a transfer to a trust for an estate tax or gift tax marital deduction under Section 2056 or 2523 of the Internal Revenue Code of 1986[, as amended][, 26 U.S.C. Section 2056 or 2523][, as amended] that depends or depended in whole or in part on the right of the transferor's spouse to receive the net income of the trust;

(D) exemption in whole or in part of a trust from the federal generation-skipping transfer tax imposed by Section 2601 of the Internal Revenue Code of 1986[, as amended][, 26 U.S.C. Section 2601][, as amended] because the trust was irrevocable on September 25, 1985; and

(E) an inclusion ratio, as defined in Section 2642(a) of the Internal Revenue Code of 1986[, as amended][, 26 U.S.C. Section 2642(a)][, as amended], of the trust that is less than one, if there is any possibility that:

(i) a taxable distribution as defined in Section 2612(b) of the Internal Revenue Code of 1986[, as amended][, 26 U.S.C. Section 2612(b)][, as amended] could be made from the trust; or

(ii) a taxable termination as defined in Section 2612(a) of the Internal Revenue Code of 1986[, as amended][, 26 U.S.C. Section 2612(a)][, as amended] could occur with respect to the trust.

(5) "Unitrust" means a trust

(A) for which net income is a unitrust amount under subsection (d)(2)(A)(i), and

(B) that meets the requirements of a policy described in subsection (o).

(6) "Unitrust amount" means an amount computed by multiplying the net fair market value of the trust by the unitrust rate.

(7) "Unitrust rate" means the rate used to compute the unitrust amount under paragraph (6), determined pursuant to a policy described in subsection (o).

(b) This section does not apply to an estate.

(c) This section does not apply to a trust if:

(1) the terms of the trust expressly prohibit the use of this section by a specific reference to this section or by an explicit expression of intent that net income not be calculated as a unitrust amount;

(2) the trust is a trust described in Section 170(f)(2)(B), 642(c)(5), 664(d), 2702(a)(3), or 2702(b) of the Internal Revenue Code of 1986[, as amended][, 26 U.S.C. Section 170(f)(2)(B), 642(c)(5), 664(d), 2702(a)(3), or 2702(b)][, as amended]; or

(3) one or more persons to whom the trustee could distribute income have a power of withdrawal over the trust which:

(A) is not subject to an ascertainable standard as defined in Section 2041 or 2514 of the Internal Revenue Code of 1986[, as amended][, 26 U.S.C. Sections 2041 or 2514][, as amended], and exceeds in any calendar year the amount set forth in Section 2041(b)(2) or 2514(e) of the Internal Revenue Code of 1986[, as amended][, 26 U.S.C. Section 2041(b)(2) or 2514(e)][, as amended]; or

(B) may be exercised to discharge a duty of support a holder of the power of withdrawal has.

(d) A trustee may, without court approval, convert an income trust to a unitrust, convert a unitrust to an income trust, or change the percentage or method used to calculate the unitrust amount if:

(1) the trustee is a disinterested person;

(2) the trustee adopts a policy in a record for the trust providing:

(A) for an income trust,

(i) that for administering the trust in the future the net income of the trust shall be a unitrust amount rather than net income determined without regard to this section; and

(ii) the percentage and method used to calculate the unitrust amount; or

(B) for a unitrust,

(i) that for administering the trust in the future the net income of the trust shall be net income determined without regard to this section rather than a unitrust amount; or

(ii) that the percentage or method used to calculate the unitrust amount shall be changed as stated in the policy;

(3) the trustee sends a notice[,in a manner authorized under ________,] to:

(A) [the qualified beneficiaries of the trust determined under ______________, other than the Attorney General] [all beneficiaries that receive or are entitled to receive income from the trust or are entitled to receive a distribution of principal if the trust is terminated at the time the notice is sent, assuming no power of appointment is exercised];

(B) the settlor of the trust, if living; and

(C) each person acting as[advisor or protector] of the trust;

(4) at least one[member of][each class of][qualified beneficiaries] receiving the notice described in paragraph (3) is:

(A) legally competent;

(B) in the case of a charitable organization, then existing; or

[(C) represented in the manner provided in subsection (e)]; and

(5) the trustee does not receive a written objection to the action proposed under this subsection from a person to whom the notice under paragraph (3) is sent by the date specified in the notice under subsection (g)(4).

[(e) The representation provisions of ________________ apply to notice under subsection (d)(3).]

(f) The notice under subsection (d)(3) need not be sent to a person that consents in a record to the action proposed under subsection (d). The consent may be executed and delivered at any time before or after the proposed action is taken.

(g) The notice under subsection (d)(3) must include:

(1) notice of the action proposed under subsection (d);

(2) a copy of the policy in a record under subsection (d)(2);

(3) a statement that the person to which the notice is sent may object to the action in a record stating the basis or reason for the objection by mailing or delivering the record to the trustee;

(4) the date by which an objection under paragraph (3) must be made, which may not be less than 30 days after the date the notice is sent;

(5) the date on which the action is proposed to be taken and, if different, the date on which the action is proposed to take effect;

(6) the name and mailing address of the trustee; and

(7) the name and telephone number of a person that may be contacted for additional information.

(h) If the trustee receives a written objection described in subsection (g)(3) not later than the date stated in the notice under subsection (g)(4), the trustee or a beneficiary may petition the court to have the proposed action taken as proposed, taken with modifications, or denied. A person described in subsection (d)(3) may oppose the action proposed under subsection (d) in the proceeding under this subsection, regardless of whether the person has:

(1) consented under subsection (f); or

(2) objected under subsection (g)(3).

(i) If a trustee decides not to take the action proposed under subsection (d), the trustee shall notify each person described in subsection (d)(3) of the decision not to take the action and the reasons for the decision.

(j) If a trustee is not a disinterested person and one or more trustees are disinterested persons, the trustees that are disinterested persons may take the action described in subsections (d), (h), or (i).

(k) If no trustee is a disinterested person, the trustee may appoint a disinterested person to take an action described in subsection (d) or (h) in the disinterested person's sole discretion exercised in a fiduciary capacity.

(*l*) If no trustee is a disinterested person, or if the trustee chooses not to take an action under subsection (d), (h), or (k), the trustee or a beneficiary may petition the court for approval of any of the actions described in subsection (d) or (h).

(m) In deciding whether and how to take any action authorized by this section, a trustee shall consider all factors relevant to the trust and its beneficiaries, including the relevant factors stated in Section 301(e).

(n) An income trust may be converted to a unitrust under this section regardless of the terms of the trust concerning distributions. Conversion to a unitrust under this section does not affect other terms of the trust concerning distributions of income or principal.

(o) In administering a unitrust under this section, the trustee shall follow the policy adopted under subsection (d)(2). The policy may provide for:

(1) a fixed unitrust rate stated in the policy;

(2) a unitrust rate that is determined for each period using:

(A) a market index or other published data; or

(B) a mathematical blend of market indices or other published data over a stated number of previous periods;

(3) a limit on how high the unitrust rate determined under paragraph (2) may rise;

(4) a limit on how low the unitrust rate determined under paragraph (2) may fall;

(5) a limit on how much the unitrust rate determined under paragraph (2) may increase over the unitrust rate for the previous period or a mathematical blend of unitrust rates over a stated number of previous periods;

(6) a limit on how much the unitrust rate determined under paragraph (2) may decrease below the unitrust rate for the previous period or a mathematical blend of unitrust rates over a stated number of previous periods;

(7) the period used under paragraphs (2), (5), and (6), which may be:

(A) a calendar year or quarter;

(B) a 12-month or three-month period other than a calendar year or quarter; or

(C) another period;

(8) a standard for using a fewer number of previous periods under paragraphs (2),

(5), and (6) if the trust has not been in existence for the previous periods or market indices or other published data are not available;

(9) a mathematical blend of any of the unitrust rates determined under paragraphs (2) through (8);

(10) methods for determining fair market value for calculating the unitrust amount, including:

(A) the frequency of valuing an asset, which need not require a valuation in every period;

(B) the date for valuing an asset in each period in which the asset is valued;

(C) for calculating the unitrust amount, a limit on how much the fair market value of all assets, groups of assets, or individual assets, may increase over:

(i) the corresponding fair market value for the previous period; or

(ii) a mathematical blend of fair market values over a stated number of previous periods;

(D) for calculating the unitrust amount, a limit on how much the fair market value of all assets, groups of assets, or individual assets may decrease below:

(i) the corresponding fair market value for the previous period; or

(ii) a mathematical blend of fair market values over a stated number of previous periods;

(E) use of an average of fair market values over a stated number of previous periods;

(F) use of another mathematical blend of fair market values over a stated number of previous periods; and

(G) the treatment of accrued income and other financial features of an asset;

(11) the period used under paragraph (10), which may be:

(A) a calendar year or quarter;

(B) a 12-month or three-month period other than a calendar year or quarter; or

(C) another period;

(12) standards for:

(A) the exclusion of specific assets or groups or types of assets from the calculation of the unitrust amount;

(B) other exceptions or modifications of the treatment of specific assets or groups or types of assets in the calculation of the unitrust amount; and

(C) how the net income attributable to an asset excluded under subparagraph (A) or given special treatment under subparagraph (B) must be determined and the effect of the net income on distributions;

(13) standards for:

(A) using a fewer number of previous periods under paragraph (10) if the trust has not been in existence for the previous periods or fair market values are not available;

(B) obtaining an appraisal of an asset for which market value is not readily available;

(C) identification and treatment of cash or property held for distribution to determine the fair market value of the assets of the trust;

(D) identification and measurement of liabilities of the trust to determine the net fair market value of the trust;

(E) the timing of distributions;

(F) making distributions in cash or in kind or partly in cash and partly in kind;

(G) prorating the unitrust amount[on a daily basis] for a part of a period in which the trust or the administration of the trust as a unitrust or the interest of any beneficiary commences or terminates; and

(H) correcting an underpayment or overpayment to a beneficiary based on the unitrust amount if there is an error in calculating the unitrust amount; and

(14) other standards and rules the trustee determines serve the interests of the trust and the beneficiaries.

(p) If a trust qualifies for any tax benefit:

(1) the unitrust rate established under subsection (o)(1) may not be less than three percent or more than five percent;

(2) the only period that may be used under subsection (o)(11) is a calendar year; and

(3) no other provision of subsection (o) applies, except subsections (o)(10)(A), (o)(10)(E), and (o)(13).

(q) A trustee or disinterested person may take action under this section regardless of whether the trustee has adopted a policy under Section 301 or is allocating receipts and disbursements between income and principal under [Articles] 6 through 9.

(r) This power may be released for the reasons and in the manner described in Section

401(e).

(s) This section does not create or imply a duty to take action or to inform beneficiaries about the applicability of this section. A trustee or disinterested person that in good faith takes or fails to take any action under this section is not liable to a person affected by the action or inaction, regardless of whether the affected person received written notice as provided in this section or the affected person was under a legal disability at the time of delivery of the notice. The exclusive remedy of a person affected by the good-faith action or inaction under this section of a trustee or disinterested person is to obtain a court order directing the trustee to convert an income trust to a unitrust, to convert a unitrust to an income trust, or to change the percentage or method used to calculate the unitrust amount.

Drafting Note: *The approximately 11 states (Delaware, Florida, North Carolina, South Carolina, South Dakota, Tennessee, Utah, Vermont, Virginia, West Virginia, and Wyoming) that define a "disinterested person" define it as someone who is not a related or subordinate party (within the meaning of section 672(c) of the Internal Revenue Code) with respect to a person then acting as trustee of the trust. In contrast, Section 501(a)(1) of this draft uses any beneficiary of the trust as the reference, not the trustee.*

Legislative Note: *In states in which the constitution, or other law, does not permit the phrase "as amended" when federal statutes are incorporated into state law, the phrase should be omitted. Modify the introductory provision of Section 501(d)(3) to refer to appropriate general provisions for sending notice. Modify Sections 501(d)(3)(A) and 501(d)(4) to refer to Section 103(13) (defining "qualified beneficiary") and related provisions of the Uniform Trust Code, or modify those provisions appropriately if your state has not adopted the Uniform Trust Code. Modify Section 501(d)(3)(C) to refer to appropriate provisions defining and addressing trust advisors and trust protectors, perhaps in light of the Uniform Directed Trust Act, or modify or delete Section 501(d)(3)(C) as appropriate if your state law has no such provisions. Modify Section 501(e) to refer to Article 3 and other provisions of the Uniform Trust Code defining and addressing representation, or modify or delete Sections 501(d)(4)(C) and 501(e) as appropriate if your state has not adopted the Uniform Trust Code.*

Comment

Background. The word "unitrust" can be traced at least to the literature of the mid-1960s. Lovell, "The Unitrust: A New Concept to Meet an Old Problem," 105 TRUSTS & ESTATES 215 (1966); Del Cotto & Joyce, "Taxation of the Trust Annuity: The Unitrust Under the

Constitution and the Internal Revenue Code," 23 TAX L. REV. 257 (1968). For many estate planners and charitable giving planners, the first introduction to the word may be in the term "charitable remainder unitrust" introduced by Congress in section 664, added to the Internal Revenue Code by the Tax Reform Act of 1969. The word was reprised following the enactment of section 2702 in Treasury Reg. § 25.2702-3(c), governing "qualified unitrust interests" in grantor retained unitrusts ("GRUTs") (which are hardly ever used, if they are used at all).

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

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

Converting or reforming an income trust to a unitrust can provide a partnership among the income beneficiaries, the remainder beneficiaries, and the trustee that will enable the trustee to invest the assets for long-term growth to the benefit of all beneficiaries. This will permit the mission of the trustee and investment team to become more focused. Investment decisions can be based on the needs and risk tolerances of the beneficiaries, and there is less likelihood of dissension between the current and future beneficiaries over investment policy. In addition, to the extent that a unitrust approach obviates discretionary invasions of principal, the trustee is protected against challenges by the remainder beneficiaries that any discretionary principal distributions were excessive. Similarly, a unitrust approach eliminates the need to make adjustments between income and principal under Section 401 and thus avoids or minimizes controversy over whether such adjustments are proper.

By the end of 2016, 34 states (Alabama, Alaska, Arizona, California, Colorado, Delaware, Florida, Georgia, Illinois, Indiana, Iowa, Kansas, Kentucky, Maine, Maryland, Missouri, Nebraska, Nevada, New Hampshire, New York, North Carolina, Oregon, Pennsylvania, Rhode Island, South Carolina, South Dakota, Tennessee, Utah, Vermont, Virginia, Washington, West Virginia, Wisconsin, and Wyoming) had enacted statutes, some as part of their Uniform Principal and Income Act and some separately, permitting a trustee to convert an income trust to a unitrust. Some of those statutes refer to unitrusts as "total return unitrusts" (a term not used in Section 501).

Response by the Internal Revenue Service. In February 2001, the Internal Revenue Service published proposed regulations it described in part as follows: "This document contains proposed regulations revising the definition of income under section 643(b) of the Internal Revenue Code to take into account changes in the definition of trust accounting income under state laws." The preamble to the proposed regulations noted:

> These [then current] statutory and regulatory provisions [under section 643] date back to a time when, under state statutes, dividends and interest were considered income and were allocated to the income beneficiaries while capital gains were allocated to the principal of the trust. Changes in the types of available investments and in investment philosophies have caused states to revise, or to consider revising, these traditional concepts of income and principal….
>
> To ensure that the income beneficiaries are not penalized if a trustee adopts a total return investment strategy, many states have made, or are considering making, revisions to the definitions of income and principal. Some state statutes permit the trustee to make an equitable adjustment between income and principal if necessary to ensure that both the income beneficiaries and the remainder beneficiaries are treated impartially, based on what is fair and reasonable to all of the beneficiaries. Thus, a receipt of capital gains that previously would have been allocated to principal may be allocated by the trustee to income if necessary to treat both parties impartially. Conversely, a receipt of dividends or interest that previously would have been allocated to income may be allocated by the trustee to principal if necessary to treat both parties impartially.
>
> Other states are proposing legislation that would allow the trustee to pay a unitrust amount to an income beneficiary in satisfaction of that beneficiary's right to the income from the trust. This unitrust amount will be a fixed percentage, sometimes required to be within a range set by state statute, of the fair market value of the trust assets determined annually.
>
> Questions have arisen concerning how these state statutory changes affect the definition of income provided in section 643(b) and the other Code provisions that rely on the section 643(b) definition of income. This definition of income affects trusts including, but not limited to, ordinary trusts, charitable remainder trusts, pooled income funds, and qualified subchapter S trusts.

In short, amendment of the regulations was proposed to respond to changes in circumstances, including changes in the pressures on a trustee faced with an obligation to invest for total return under the prudent investor rule and faced with the remedies of principal-income adjustments under the Revised Uniform Principal and Income Act and of conversion to a total return unitrust.

The final regulations were released on December 30, 2003. Treasury Reg. §1.643(b)-1 states, in part:

> [A]n allocation of amounts between income and principal pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, including ordinary and tax-exempt income, capital gains, and appreciation. For example, a state statute providing that income is a unitrust amount of no less than 3% and no more than 5% of the fair market value of the trust assets, whether determined annually or averaged on a multiple year basis, is a reasonable apportionment of the total return of the trust.

Section 501. The typical state unitrust statute limits unitrust conversions to the parameters in the Treasury Regulations – "a unitrust amount of no less than 3% and no more than 5% of the fair market value of the trust assets, whether determined annually or averaged on a multiple year basis." Section 501 borrows heavily from that state legislation, but it is broader and more flexible than the laws of most states. The Drafting Committee decided that state law should not be limited by specialized federal regulations and have included in Section 501 many more features and refinements than only a 3-5% range and the potential for annual averaging, to permit a unitrust to even better serve the objective of achieving more stability and predictability for beneficiaries.

One such refinement is to provide that the trust distribute a percentage of its market value determined on the basis of a rolling average of values for periods other than years. Twelve quarters is an example. This can reduce potential fluctuations in distributions caused by short-swing movements in the stock market. Although the rate of increase in the unitrust distribution to the current income beneficiary will lag the performance of the portfolio, the current income beneficiary will benefit in down years. Another similar refinement designed to reduce risk to all the beneficiaries is to place a ceiling and/or a floor on the unitrust payout amount, or on the size of fluctuation of the unitrust amount from year to year or period to period. More fundamental refinements include a variable unitrust rate itself, perhaps drawn from specified market data, and different treatment for different types of assets, including the total exclusion of certain assets and the income therefrom.Section 501(o) allows all variations of that kind. To afford a trustee the benefit of the safe harbor in the Treasury regulations in situations where it applies, Section 501(p) limits the parameters in those situations to the parameters specified in that safe harbor. The situations where Section 501(p) applies, described as situations in which the trust offers a "tax benefit" defined in Section 501(a)(4), are limited to the situations addressed in the 2003 Treasury Regulations.

Because of the broad flexibility Section 501 allows, it is not necessary to provide specific fixes for specific identified challenges, including computational challenges like the treatment of accrued but unpaid income and the treatment of property that is personally used and not invested.

The term "interested person," defined in Section 501(a)(1), is an important element of the unitrust provisions in many states and seems to uniquely fit the unitrust context, even though it is not used in previous versions of the Uniform Principal and Income Act or in the Uniform Trust Code.

In addition to the requirements in Section 501(g), some states also require the trustee to send a copy of this section of the statute. If the other, somewhat more detailed, requirements of this Section 501 are followed, that seems unnecessary, although any state that chooses may still add it.

Section 501(n) provides that a trust may be converted to a unitrust regardless of the terms of the trust governing distributions – that is, even though distributions are not defined or limited by the amount of net income of the trust. This is a departure from current state laws, but it reflects the overall commitment to flexibility that is a theme of the current revision of the Act. The definition of an "income trust" in Section 501(a)(2) is conformed to this decision.

[ARTICLE] 6

DECEDENT'S ESTATE OR TERMINATING INCOME INTEREST

SECTION 601. DETERMINATION AND DISTRIBUTION OF NET INCOME.

(a) In this section, "fiduciary" means a trustee or a personal representative, successor personal representative, executor, administrator, special administrator, or a person performing substantially the same function.

(b) 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 of 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] 7 through 9 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 net income of a decedent's estate or a terminating income interest, other than the amount of net income determined under paragraph (1), under the rules in [Articles] 7 through 9 which apply to trustees and by:

(A) including in net income all income from property used or sold 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 the payment of those expenses from income will not cause the reduction or 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, to the extent authorized by the decedent's will, the terms of the trust, or applicable law, 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 decedent's will, the terms of the trust, or applicable law.

(3) A fiduciary shall distribute to a beneficiary who receives a pecuniary amount outright the interest or any other amount provided by the decedent's will, the terms of the trust, or applicable law from net income determined under paragraph (2) or from principal to the extent net income is insufficient. If a beneficiary is to receive a pecuniary amount outright from a trust after an income interest ends and no interest or other amount is provided for by the terms of the trust or applicable law, the fiduciary shall distribute the interest or other 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 602 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 901 or 902 to the extent the decedent's 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 the fiduciary recovers or expects to recover the payment from a third party. The net income and principal receipts from the property are determined by including all 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 the fiduciary believes the estate or terminating income interest may become obligated to pay after the property is distributed.

Comment to 1997 Act

Terminating income interests and successive income interests. A trust that provides for a single current income beneficiary and an outright distribution of the remainder ends when the income interest ends. A more complex trust may have a number of income interests, either concurrent or successive, and the trust will not necessarily end when one of the income interests ends. For that reason, the Act speaks in terms of income interests ending and beginning rather than trusts ending and beginning. When an income interest in a trust 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, e.g., when a beneficiary dies, the beneficiary's income interest ends but the trust does not. Similarly, when a trust with only one current 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 current income beneficiary exercises a general power of appointment over the trust assets, the recipient trust would be a new trust; and if they pass to another trust because the beneficiary exercises a nongeneral power of appointment over the trust assets, the recipient trust might be a new trust in some States (see 5A Austin W. Scott & William F. Fratcher, The Law of Trusts § 640, at 483 (4th ed. 1989)); but for purposes of this Act a new trust created in these circumstances is also a successive income interest.

Gift of a pecuniary amount. Section 601(3) and (4) provide different rules for an outright gift of a pecuniary amount and a gift in trust of a pecuniary amount; this is the same approach used in Section 5(b)(2) of the 1962 Act.

Interest on pecuniary amounts. Section 601(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 or some other amount to be paid on an outright pecuniary gift under an inter vivos trust; this section provides that in such a case the interest or other amount to be paid shall be the same as the interest or other amount required to be paid 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 (4th ed. 1997).

Administration expenses and interest on death taxes. Under Section 601(2)(B) a fiduciary may pay administration expenses and interest on death taxes from either income or principal. An advantage of permitting the fiduciary to choose the source of the payment is that, if the fiduciary's decision is consistent with the decision to deduct these expenses for income tax purposes or estate tax purposes, it eliminates the need to adjust between principal and income that may arise 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.

The United States Supreme Court has considered the question of whether an estate tax marital deduction or charitable deduction should be reduced when administration expenses are paid from income produced by property passing in trust for a surviving spouse or for charity and deducted for income tax purposes. The Court rejected the IRS position that administration expenses properly paid from income under the terms of the trust or state law must reduce the amount of a marital or charitable transfer, and held that the value of the transferred property is not reduced for estate tax purposes unless the administration expenses are material in light of the income the trust corpus could have been expected to generate. *Commissioner v. Estate of Otis C. Hubert*, 117 S.Ct. 1124 (1997). The provision in Section 601(2)(B) permits a fiduciary to pay and deduct administration expenses from income only to the extent that it will not cause the reduction or loss of an estate tax marital or charitable contributions deduction, which means that the limit on the amount payable from income will be established eventually by Treasury Regulations.

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. For estates of persons who died before 1998, a fiduciary may not want to deduct for income tax purposes interest on estate tax that is deferred under Section 6166 or 6163 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. For estates of persons who die after 1997, no federal estate tax or income tax deduction will be allowed for interest paid on estate tax that is deferred under Section 6166. However, interest on estate tax deferred under Section 6163 will continue to be deductible for both purposes, and interest on estate tax deficiencies will continue to be deductible for estate tax purposes if an election under Section 6166 is not in effect.

Under the 1962 Act, Section 13(c)(5) charges interest on estate and inheritance taxes to principal. The 1931 Act has no provision. Section 901(3) of this Act provides that, except to the extent provided in Section 601(2)(B) or (C), all interest must be paid from income.

SECTION 602. DISTRIBUTION TO RESIDUARY AND REMAINDER BENEFICIARIES.

(a) Each beneficiary described in Section 601(4) is entitled to receive a part of the net income equal to the beneficiary's fractional interest in undistributed principal assets, using values as of the distribution date. If a trustee 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 trustee 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 part 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

(A) property specifically given to a beneficiary; and

(B) 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 trustee calculates the value of the assets if that date is reasonably near the date on which the assets are actually distributed.

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

(d) A trustee may apply the rules in this section, to the extent the trustee considers it appropriate, 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.

Comment

Section 602(b)(2) excludes specific bequests in kind and pecuniary bequests from the calculation of a beneficiary's fractional interest of undistributed principal assets for purposes of allocating income to that beneficiary. If the beneficiary is entitled to statutory interest on any such bequest, that interest is not income subject to allocation under this section, and that bequest does not share in the income earned by the other assets.

Comment to 1997 Act

Relationship to prior Acts. Section 602 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 their 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 91 (4th ed. 1998); Thomas H. Cantrill, Fractional or Percentage Residuary Bequests: Allocation of Postmortem Income, Gain and Unrealized Appreciation, 10 Prob. Notes 322, 327 (1985).

[ARTICLE] 7

APPORTIONMENT AT BEGINNING AND END OF INCOME INTEREST

SECTION 701. WHEN RIGHT TO INCOME BEGINS AND ENDS.

(a) A current income beneficiary or successor 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:

(1) becomes subject to the trust in the case of the current income beneficiary; or

(2) become subject to a successive income interest in the case of a successor beneficiary.

(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 trustee 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, or on the last day of a period during which there is no beneficiary to whom a trustee may distribute income.

Comment to 1997 Act

Period during which there is no beneficiary. The purpose of the second part of subsection (d) is to provide that, at the end of a period during which there is no beneficiary to whom a trustee may distribute income, the trustee must apply the same apportionment rules that apply when a mandatory income interest ends. This provision would apply, for example, if a settlor creates a trust for grandchildren before any grandchildren are born. When the first grandchild is born, the period preceding the date of birth is treated as having ended, followed by a successive income interest, and the apportionment rules in Sections 702 and 703 apply accordingly if the terms of the trust do not contain different provisions.

SECTION 702. APPORTIONMENT OF RECEIPTS AND DISBURSEMENTS WHEN DECEDENT DIES OR INCOME INTEREST BEGINS.

(a) A trustee shall allocate an income receipt or disbursement other than one to which Section 601(1) applies to principal if its due date occurs before the date on which a decedent dies in the case of an estate or before the date on which an income interest begins in the case of a trust or successive income interest.

(b) A trustee shall allocate an income receipt or disbursement 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 part 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 the payer is required to make a payment. If a payment date is not stated, there is no due date for purposes of this [act]. Distributions to shareholders or other owners from an entity to which Section 801 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

The change to "before the date on which a decedent dies" and "before the date on which an income interest begins" in Section 702(a) makes this provision consistent with the reference to "the date of a testator's death" in Section 701(b)(2) and consistent with the reference to "on or after the date on which a decedent dies" in Section 702(b). It means that the time of day at which the moment of death occurs is less relevant and therefore less important to determine. In effect, the decedent's income interest ends with the day before the date of death, and the estate's income interest begins with the date of death. Accounting periods based on a single day are easiest to administer in a global economy where the actual time of death might otherwise appear to be affected by arbitrary time zones. This rule in a uniform act does not purport to directly address related income tax uncertainties, although it may contribute in the long term to uniformity in that context as well.

Comment on 1997 Act

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." George G. 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 702 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 702, 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 will help to maintain payments to the spouse 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 Section 702(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 601(1) to the person who receives the obligation. The same rule applies to interest on an obligation that has a due date but does not provide for periodic payments. If there is no stated interest on the obligation, such as a zero coupon bond, and the proceeds from the obligation are received more than one year after it is purchased or acquired by the trustee, the entire amount received is principal under Section 806.

SECTION 703. APPORTIONMENT WHEN INCOME INTEREST ENDS.

(a) In this section, "undistributed income" means net income received on or 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 under 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 under 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. If the beneficiary has an unqualified power to revoke more than five percent of the trust immediately before the income interest ends, the undistributed income from the part 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 1997 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.

The current Drafting Committee is not as sure that the estate rule is not what most settlors would want. The estate rule may actually fit best with the paradigm of a beneficiary accruing bills, like credit card charges and unreimbursed medical expenses, that are paid in arrears from trust distributions. At the other end of the wealth spectrum, payment to the estate might create an avoidable increment of estate tax as well as administrative burden, but those situations would typically entail more sophisticated estate planning that can draft around that. Moreover, the estate rule would avoid the pressure to make or demand income distributions at more frequent intervals in order to keep the distributions more current up to the date of death. The payment of "stub income" to the income beneficiary's estate also provides better protection in cases where tax rules require a beneficiary to receive income "for life."

Accrued periodic payments. 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 of income that accrue over a longer period of time; the rule also applies to expenses that are due or accrued.

Example – accrued periodic payments. The rules in Section 702 and Section 703 work in the following manner: Assume that a periodic payment of rent that is due on July 20 has not been paid when an income interest ends on July 30; the successive income interest begins on July 31, and the rent payment that was due on July 20 is paid on August 3. Under Section 702(a), the July 20 payment is added to the principal of the successive income interest when received. Under Section 702(b), the entire periodic payment of rent that is due on August 20 is income when received by the successive income interest. Under Section 703, neither the income beneficiary of the terminated income interest nor the beneficiary's estate is entitled to any part of either the July 20 or the August 20 payments because neither one was received before the income interest ended on July 30. The same principles apply to expenses of the trust.

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 to the extent 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. The assumption underlying this rule is 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 willing 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] 8

ALLOCATION OF RECEIPTS DURING ADMINISTRATION OF TRUST

[PART 1

RECEIPTS FROM ENTITIES]

SECTION 801. CHARACTER OF RECEIPTS.

(a) In this section, “entity” means a corporation, partnership, limited liability company, regulated investment company, real estate investment trust, common trust fund, or any other organization in which a trustee has an interest other than a trust or estate to which Section 702 applies, a business or activity to which Section 803 applies, an asset-backed security to which Section 815 applies, or an instrument or arrangement to which Section 816 applies.

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

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

(1) property, of more than trivial or immaterial value, other than money;

(2) money 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) money received in total or partial liquidation of the entity; and

(4) money received from an entity that is:

(A) a regulated investment company or a real estate investment trust if the money distributed is a capital gain dividend for federal income tax purposes; or

(B) an entity or arrangement treated comparably for federal income tax purposes to the treatment describe in paragraph (4)(A).

(d) Money is received in partial liquidation:

(1) to the extent 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 of money and property distributed in a distribution or series of related distributions to all owners or distributees is greater than 20 percent of the net value of the entity's assets, as shown by the entity's year-end financial statements immediately preceding the initial receipt.

(e) Money is not received in partial liquidation, nor may it be taken into account under subsection (d)(2), to the extent 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 money.

(f) A trustee may rely on 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.

Drafting Note: *This section could still benefit from the input of representatives of financial institutions.*

Comment

Additional flexibility. The references to Section 816 at the end of Section 801(a) and to entities comparably treated for federal income tax purposes in Section 801(c)(4)(B) provide necessary guidance that may stay up-to-date even as new entities and arrangements are developed to serve various tax needs and objectives.

The current Act substitutes net assets for gross assets in Section 801(d)(2) to provide a test that is realistic in the context of a highly-leveraged business where 20 percent of the gross value of the assets may actually exceed the net value of the assets or the fair market value of the entity. It also clarifies that all related distributions, not just distributions received by the owner in question, must be taken into account.

Comment to 1997 Act

Entities to which Section 801 applies. The reference to partnerships in Section 801(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, nor would it apply to an interest in a joint venture if, under applicable law, the trust's interest is regarded as that of a tenant in common.

Capital gain dividends. Under the Internal Revenue Code and the Income Tax Regulations, a "capital gain dividend" from a mutual fund or real estate investment trust is the excess of the fund's or trust'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 by a trust because of a net short-term capital gain is income under this Act.

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. Making or continuing such an election would be equivalent to deciding under Section 401 to transfer income to principal in order to comply with Section 103(b). However, if the trustee makes or continues the election for a reason other than to comply with Section 103(b), e.g., to make an investment without incurring brokerage commissions, the trustee should transfer cash from principal to income in an amount equal to the reinvested dividends.

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 money, Section 801 embraces all of the items enumerated in Section 6 of the 1962 Act as well as any other form of nonmonetary 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. If a distribution exceeds 20% of the entity's net assets, the entire distribution is a partial liquidation under subsection (d)(2) whether or not the entity describes it as a partial liquidation. In determining whether a distribution is greater than 20% of the gross assets, the portion of the distribution that does not exceed the amount of income tax that the trustee or a beneficiary must pay on the entity's taxable income is ignored.

Other large distributions. A cash distribution 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 it should be treated as principal rather than income. For example, an entity may have received cash from a source other than the conduct of 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, 90% of which would have been allocated to principal if the trust had owned the assets directly. In such a case the trustee, after considering the total return from the portfolio as a whole and the income component of that return, may decide to exercise the power under Section 401(a) to make an adjustment between income and principal, subject to the limitations in Section 401(c).

SECTION 802. DISTRIBUTION FROM TRUST OR ESTATE. A trustee shall allocate to income an amount received as a distribution of income from a trust or an estate in which the trust has an interest other than a purchased interest, and shall allocate to principal an amount received as a distribution of principal from such a trust or estate. If a trustee purchases an interest in a trust that is an investment entity, or a decedent or donor transfers an interest in such a trust to a trustee, Section 801 or 815 applies to a receipt from the trust.

Comment to 1997 Act

Terms of the distributing trust or estate. Under Section 103(a), a trustee is to allocate receipts in accordance with the terms of the recipient trust or, if there is no provision, in accordance with this Act. However, in determining whether a distribution from another trust or an estate is income or principal, the trustee should also determine what the terms of the distributing trust or estate say about the distribution – for example, whether they direct that the distribution, even though made from the income of the distributing trust or estate, is to be added to principal of the recipient trust. Such a provision should override the terms of this Act, but if the terms of the recipient trust contain a provision requiring such a distribution to be allocated to income, the trustee may have to obtain a judicial resolution of the conflict between the terms of the two documents.

Investment trusts. An investment entity to which the second sentence of this section applies includes a mutual fund, a common trust fund, a business trust or other entity organized as a trust for the purpose of receiving capital contributed by investors, investing that capital, and managing investment assets, including asset-backed security arrangements to which Section 815 applies. See John H. Langbein, The Secret Life of the Trust: The Trust as an Instrument of Commerce, 107 Yale L.J. 165 (1997).

SECTION 803. 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. The trustee may make those determinations separately and differently from the trustee's decisions concerning distributions of income or principal. 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 a 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;

(7) activities to which Section 814 applies; and

(8) other operating businesses.

Drafting Note: *This section could still benefit from the input of representatives of financial institutions.*

Comment

Separate accounting. The second sentence of subsection (b) is added to accommodate the concept of "separate accounting" in a trust the only activity of which (other than making distributions to beneficiaries) is the conduct of a business. It may not be reasonable to assume that receipts not distributed to beneficiaries have been "retained" for use in the business, if that permits discretionary distributions to beneficiaries, in effect, to define trust income. That might be especially awkward if discretionary distributions of either income or principal or both to multiple beneficiaries are not made pro rata. In such a case, the trustee is permitted to designate which distributions in effect define trust income, and which distributions are discretionary distributions under the terms of the trust not intended to be a standard or precedent for defining income.

Comment to 1997 Act

Purpose and scope. The provisions in Section 803 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 allocated to 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, timber operations, and activities in derivatives and options 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 803 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 trustee liquidates a sole proprietorship or other activity to which Section 803 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 601.

Separate accounts. A trustee may or may not maintain separate bank accounts for business activities that are accounted for under Section 803. 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 804. PRINCIPAL RECEIPTS. A trustee shall allocate to principal:

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

(2) money 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 902(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 an accounting 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].

Drafting Note: *This could still benefit from input from accountants, with regard to consistency with FASB smoothing rules and other standards, GAAP, etc., with regard to the accuracy of terms such as "realized profit" and "accounting period," and with regard to the limitation in Section 804(3) to environmental matters addressed in Section 902(a)(7).*

Comment to 1997 Act

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 805. RENTAL PROPERTY. To the extent a trustee accounts for receipts from rental property pursuant to this section, the trustee shall allocate to income an amount received as rent of real or personal property, including an amount received for cancellation or renewal of a lease. 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 to 1997 Act

Application of Section 803. This section applies to the extent that the trustee does not account separately under Section 803 for the management of rental properties owned by the trust.

Receipts that are capital in nature. A portion of the payment under a lease may be a reimbursement of principal expenditures for improvements to the leased property that is characterized as rent for purposes of invoking contractual or statutory remedies for nonpayment. If the trustee is accounting for rental income under Section 805, a transfer from income to reimburse principal may be appropriate under Section 904 to the extent that some of the "rent" is really a reimbursement for improvements. This set of facts could also be a relevant factor for a trustee to consider under Section 401(b) in deciding whether and to what extent to make an adjustment between principal and income under Section 401(a) after considering the return from the portfolio as a whole.

SECTION 806. 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 a trustee, including an amount received as consideration for prepaying principal, must be allocated to income without any provision for amortization of premium.

(b) A trustee shall allocate to principal 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. If the obligation matures not later than 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 an obligation to which Section 809, 810, 811, 812, 814, or 815 applies.

Drafting Note: *This could also benefit from input from accountants, with regard to the types of interest rates, the limitation to "more than one year," the exceptions in subsection (c), etc.*

Comment to 1997 Act

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 814.

Discount obligations. Subsection (b) applies to all obligations acquired at a discount, including short-term obligations such as U.S. Treasury Bills, 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 the proceeds from the disposition 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 401. In deciding whether and to what extent to exercise the power to adjust between principal and income granted by Section 401(a), a relevant factor for the trustee to consider is the effect on the portfolio as a whole of having a portion of the assets invested in bonds that do not pay interest currently.

SECTION 807. INSURANCE POLICIES AND SIMILAR CONTRACTS.

(a) Except as otherwise provided in subsection (b), a trustee shall allocate to principal the proceeds of a life insurance policy or other contract in which the trust or its trustee is named as beneficiary, including a contract that insures the trust or its trustee against loss for damage to, destruction of, or loss of title to a trust asset. The trustee shall allocate dividends on an insurance policy to income if the premiums on the policy are paid from income, and to principal if the premiums are paid from principal.

(b) A trustee shall allocate to income proceeds of a contract that insures the trustee against loss of occupancy or other use by a current income beneficiary, loss of income, or, subject to Section 803, loss of profits from a business.

(c) This section does not apply to a contract to which Section 809 applies.

[PART 3

RECEIPTS NORMALLY APPORTIONED]

SECTION 808. INSUBSTANTIAL ALLOCATIONS NOT REQUIRED. If a trustee determines that an allocation between income and principal required by Section 809, 810, 811, 812, or 815 is insubstantial, the trustee may allocate the entire amount to principal unless one of the circumstances described in Section 301(f) applies to the allocation. This power may be exercised by a cotrustee in the circumstances described in Section 401(d) and may be released for the reasons and in the manner described in Section 401(e). An allocation is presumed to be insubstantial if:

(1) the amount of the allocation would increase or decrease net income in an accounting period, 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 to 1997 Act

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, assume that a trust's assets, which include a working interest in an oil well, have a value of $1,000,000; the net income from the assets other than the working interest is $40,000; and the net receipts from the working interest are $400. The trustee may allocate all of the net receipts from the working interest to principal instead of allocating 10%, or $40, to income under Section 811. If the net receipts from the working interest are $35,000, so that the amount allocated to income under Section 811 would be $3,500, the trustee may decide that this amount is sufficiently significant to the current income beneficiary that the allocation provided for by Section 811 should be made, even though the trustee is still permitted under Section 808 to allocate all of the net receipts to principal because the $3,500 would increase the net income of $40,000, as determined before making an allocation under Section 811, by less than 10%. Section 808 will 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 401(c) to eliminate claims that the power in this section has adverse tax consequences.

SECTION 809. DEFERRED COMPENSATION, ANNUITIES, AND SIMILAR PAYMENTS.

(a) In this section:

(1) "Payment" means a payment 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 payer in exchange for future payments. The term includes a payment made in money or property from the payer's general assets or from a separate fund created by the payer. For purposes of subsections (e), (f), (g), and (h), the term also includes any payment from any separate fund, regardless of the reason for the payment.

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

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

(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 a percentage of the part that is required to be made during the accounting period and shall allocate 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 trustee shall allocate the entire payment to principal. For purposes of this subsection, a payment is not required to be made to the extent it is made because the trustee exercises a right of withdrawal.

(d) The percentage used under subsection (c) shall be 10 percent, unless the trustee selects a different percentage:

(1) in a policy adopted under Section 301 or

(2) by an action to change the percentage taken pursuant to the procedures in Section 301.

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

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

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

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

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

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

(i) This section does not apply to a payment to which Section 810 applies.

Comment to 1997 Act

Scope. Section 809 applies to amounts received under contractual arrangements that provide for payments to a third party beneficiary as a result of services rendered or property transferred to the payer. While the right to receive such payments is a liquidating asset of the kind described in Section 810 (i.e., "an asset whose value will diminish or terminate because the asset is expected to produce receipts for a period of limited duration"), these payment rights are covered separately in Section 809 because of their special characteristics.

Section 809 applies to receipts from all forms of annuities and deferred compensation arrangements, whether the payment will be received by the trust in a lump sum or in installments over a period of years. It applies to bonuses that may be received over two or three years and payments that may last for much longer periods, including payments from an individual retirement account (IRA), deferred compensation plan (whether qualified or not qualified for special federal income tax treatment), and insurance renewal commissions. It applies to a retirement plan to which the settlor has made contributions, just as it applies to an annuity policy that the settlor may have purchased individually, and it applies to variable annuities, deferred annuities, 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 applies whether the payments begin when the payment right becomes subject to the trust or are deferred until a future date, and it applies whether payments are made in cash or in kind, such as employer stock (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 Section 12 of the 1962 Act, receipts from "rights to receive payments on a contract for deferred compensation" are allocated to income each year in an amount "not in excess of 5% per year" of the property's inventory value. While "not in excess of 5%" 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, and since the inventory value is determined as of the date on which the payment right becomes subject to the trust, the inventory value, and thus the amount of the annual income allocation, depends significantly on the applicable interest rate on the decedent's date of death. That rate may be much higher or lower than the average long-term interest rate. The amount determined under the 5% formula tends to become fixed and remain unchanged even though the amount received by the trust increases or decreases.

Allocations Under Section 809(b). Section 809(b) applies to plans whose terms characterize payments made under the plan as dividends, interest, or payments in lieu of dividends or interest. For example, some deferred compensation plans that hold debt obligations or stock of the plan's sponsor in an account for future delivery to the person rendering the services provide for the annual payment to that person of dividends received on the stock or interest received on the debt obligations. Other plans provide that the account of the person rendering the services shall be credited with "phantom" shares of stock and require an annual payment that is equivalent to the dividends that would be received on that number of shares if they were actually issued; or a plan may entitle the person rendering the services to receive a fixed dollar amount in the future and provide for the annual payment of interest on the deferred amount during the period prior to its payment. Under Section 809(b), payments of dividends, interest or payments in lieu of dividends or interest under plans of this type are allocated to income; all other payments received under these plans are allocated to principal.

Section 809(b) does not apply to an IRA or an arrangement with payment provisions similar to an IRA. IRAs and similar arrangements are subject to the provisions in Section 809(c).

Allocations Under Section 809(c). The focus of Section 809, for purposes of allocating payments received by a trust to or between principal and income, is on the payment right rather than on assets that may be held in a fund from which the payments are made. Thus, if an IRA holds a portfolio of marketable stocks and bonds, the amount received by the IRA as dividends and interest is not taken into account in determining the principal and income allocation except to the extent that the Internal Revenue Service may require them to be taken into account when the payment is received by a trust that qualifies for the estate tax marital deduction (a situation that is provided for in Section 809(d)). An IRA is subject to federal income tax rules that require payments to begin by a particular date and be made over a specific number of years or a period measured by the lives of one or more persons. The payment right of a trust that is named as a beneficiary of an IRA is not a right to receive particular items that are paid to the IRA, but is instead the right to receive an amount determined by dividing the value of the IRA by the remaining number of years in the payment period. This payment right is similar to the right to receive a unitrust amount, which is normally expressed as an amount equal to a percentage of the value of the unitrust assets without regard to dividends or interest that may be received by the unitrust.

An amount received from an IRA or a plan with a payment provision similar to that of an IRA is allocated under Section 809(c), which differentiates between payments that are required to be made and all other payments. To the extent that a payment is required to be made (either under federal income tax rules or, in the case of a plan that is not subject to those rules, under the terms of the plan), 10% of the amount received is allocated to income and the balance is allocated to principal, unless the trustees determines that another percentage would be more appropriate (a change made in the current Act). All other payments are allocated to principal because they represent a change in the form of a principal asset; Section 809 follows the rule in Section 804(2), which provides that money or property received from a change in the form of a principal asset be allocated to principal.

Section 809(c) produces an allocation to income that is similar to the allocation under the 1962 Act formula if the annual payments are the same throughout the payment period, and it is simpler to administer. The amount allocated to income under Section 809 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.

Marital deduction requirements. When an IRA or other retirement arrangement (a “plan”) is payable to a marital deduction trust, the IRS treats the plan as a separate property interest that itself must qualify for the marital deduction. IRS Revenue Ruling 2006-26 said that, as written, Section 809 does not cause a trust to qualify for the IRS’ safe harbors. Revenue Ruling 2006-26 was limited in scope to certain situations involving IRAs and defined contribution retirement plans. Without necessarily agreeing with the IRS’ position in that ruling, the revision to this section is designed to satisfy the IRS’ safe harbor and to address concerns that might be raised for similar assets. No IRS pronouncements have addressed the scope of Code § 2056(b)(7)(C).

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

Subsection (g) also recognizes that the trustee might not control the payments that the trustee receives and provides a remedy to the surviving spouse if the distributions under subsection (e)(1) are insufficient.

Subsection (h) addresses situations where, due to lack of information provided by the fund's administrator, the trustee is unable to determine the fund's actual income. The bracketed language is the range approved for unitrust payments by Treas. Reg. § 1.643(b)-1. In determining the value for purposes of applying the unitrust percentage, the trustee would seek to obtain the value of the assets as of the most recent statement of value immediately preceding the beginning of the year. For example, suppose a trust's accounting period is January 1 through December 31. If a retirement plan administrator furnishes information annually each September 30 and declines to provide information as of December 31, then the trustee may rely on the September 30 value to determine the distribution for the following year. For funds whose values are not readily available, subsection (h) relies on Code section 7520 valuation methods because many funds described in Section 809 are annuities, and one consistent set of valuation principles should apply whether or not the fund is, in fact, an annuity.

Application of Section 401. Section 401(a) 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, the trustee determines that an adjustment is necessary. See Example (5) in the Comment following Section 401.

SECTION 810. CERTAIN ILLIQUID ASSETS.

(a) In this section, "illiquid asset" means an asset whose value is volatile or difficult to determine or will diminish or terminate because the asset is expected to produce receipts for a period of limited duration. The term includes a leasehold, patent, copyright, royalty right, and right 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 payment subject to Section 809, resources subject to Section 811, timber subject to Section 812, an activity subject to Section 814, an asset subject to Section 815, or any asset for which the trustee establishes a reserve for depreciation under Section 903.

(b) A trustee must allocate a percentage of the receipts from an illiquid asset to income and the balance to principal.

(c) The percentage used under subsection (b) shall be 10 percent, unless the trustee selects a different percentage:

(1) in a policy adopted under Section 301 or

(2) by an action to change the percentage taken pursuant to the procedures in Section 301.

Drafting Note: *This section could still benefit from the input of accountants.*

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 has a similar 5% rule that applies when the trustee is 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 current income beneficiary until the asset is exhausted. Under both the 1931 and 1962 Acts the balance of each year's receipts is added to principal. A fixed payment can 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 810 abandons the annuity approach under the 5% rule. Allowing the trustee to select a percentage other than 10% under subsection (c) is consistent with the flexibility provided by the current act in Section 103 and recognizes that a fixed percentage can be arbitrary.

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 809.

SECTION 811. MINERALS, WATER, AND OTHER NATURAL RESOURCES.

(a) To the extent a trustee accounts pursuant to this section for receipts from an interest in minerals or other natural resources not accounted for as a business under Section 803, the trustee shall allocate them as follows:

(1) If received as nominal delay rental or nominal 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 if and to the extent 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, shut-in-well payment, take-or-pay payment, bonus, or delay rental is more than nominal, a percentage must be allocated to income and the balance to principal.

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

(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, a percentage of the amount must be allocated to income and the balance to principal.

(c) The percentage used under subsection (a)(3), (a)(4), or (b) shall be 10 percent, unless the trustee selects a different percentage:

(1) in a policy adopted under Section 301 or

(2) by an action to change the percentage taken pursuant to the procedures in Section 301.

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

(e) 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 [act] 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 [act].

Drafting Note: *Input from Texas or Oklahoma colleagues would still be desirable, particularly on the question of whether reversing the calculations in subsections (a)(3), (a)(4), and (b) (which otherwise align those subsections with subsections (a)(1) and (a)(2)) does not make an unintended change in meaning.*

Comment on 1997 Act

Prior Acts. The 1962 Act allocates to principal as a depletion allowance, 27½% 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 27½% depletion allowance, although the major oil-producing States have retained the 27½% 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 811 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 wells are depleted, the amount received by the current 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.

Application of Sections 803 and 808. This section applies to the extent that the trustee does not account separately for receipts from minerals and other natural resources under Section 803 or allocate all of the receipts to principal under Section 808.

Open mine doctrine. The purpose of Section 811(c) is to abolish the "open mine doctrine" as it may apply to the rights of a current income beneficiary and a remainder beneficiary in receipts from the production of minerals from land owned or leased by a trust. Instead, such receipts are to be allocated to or between principal and income in accordance with the provisions of this Act. For a discussion of the open mine doctrine, see generally 3A Austin W. Scott & William F. Fratcher, The Law of Trusts § 239.3 (4th ed. 1988), and *Nutter v. Stockton*, 626 P.2d 861 (Okla. 1981).

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 P.2d 486, 501 (Okla. 1944). Section 811(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 5A Austin W. Scott & William F. Fratcher, The Law of Trusts § 648, at 531, 533-534; § 657, at 600 (4th ed. 1989).

SECTION 812. TIMBER.

(a) To the extent a trustee accounts for receipts from the sale of timber and related products pursuant to this section, the trustee shall allocate the net receipts:

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

(2) to principal to the extent the amount of timber removed from the land exceeds the rate of growth of the timber 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 timberland 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 advance payments, bonuses, and other payments are not allocated pursuant to paragraph (1), (2), or (3).

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

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

(d) This section does not prevent a tenant in possession of property from using wood the tenant cuts on the property for personal purposes, such as indoor or outdoor ornamentation, firewood, mending fences or building new fences, or making repairs to structures on the property.

(e) If a trust owns an interest in timberland 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 [act] or in the manner used by the trustee before [the effective date of this [act]]. If the trust acquires an interest in timberland 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 [act].

Drafting Note: *Input from colleagues from timber-producing states or regions would also be desirable, including on the clarity of the reference to "standing timber" in subsection (a)(2).*

Comment on 1997 Act

Scope of section. The rules in Section 812 are intended to apply to net receipts from the sale of trees and by-products from harvesting and processing trees without regard to 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 or for pulpwood, and trees used indoors or outdoors for ornamentation. Subsection (a) applies to net receipts from property owned by the trustee and property leased by the trustee. The Act is not intended to prevent a tenant in possession of the property from using wood that he cuts on the property for personal, noncommercial purposes, such as ornamentation, firewood, mending old fences or building new fences, or making repairs to structures on the property. Subsection (d) is added to the Act to clarify that.

Under subsection (a), 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.

Application of Sections 803 and 808. This section applies to the extent that the trustee does not account separately for net receipts from the sale of timber and related products under Section 803 or allocate all of the receipts to principal under Section 808. The option to account for net receipts separately under Section 803 takes into consideration the possibility that timber harvesting operations may have been conducted before the timber property became subject to the trust, and that it may make sense to continue using accounting methods previously established for the property. 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.

SECTION 813. MARITAL DEDUCTION PROPERTY NOT PRODUCTIVE OF INCOME.

(a) If property is transferred in a trust whose assets consist substantially of property that does not provide the transferor's spouse with sufficient income from or use of the trust assets and a marital deduction for estate or gift tax purposes that is dependent on providing the transferor's spouse with sufficient income from or use of the trust assets is allowed for all or part of the transfer, and if the amounts the trustee transfers from principal to income under Section 401 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 401(a). The trustee may decide which action or combination of actions to take.

(b) In a case not governed by subsection (a), 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 on 1997 Act

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 current 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 and not by taking into consideration the trust portfolio as a whole, which conflicts with the basic precept in Section 2(b) of the Prudent Investor Act. Moreover, in determining the amount of delayed income, the prior Acts do not permit a trustee to take into account the extent to which the trustee may have distributed principal to the current income beneficiary, under principal invasion provisions in the terms of the trust, to compensate for insufficient income from the unproductive asset. Under Sections 104(b) and 103(b)(11) of this Act, a trustee must consider prior distributions of principal to the current income beneficiary in deciding whether and to what extent to exercise the power to adjust conferred by Section 401(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 sale proceeds of an asset that produces little or no income, but it does not alter existing state law regarding the current 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 makes principal distributions to the current income beneficiary under the terms of the trust and adjustments between principal and income under Section 401 of this Act.

Trusts for which the value of the right to receive income is important for tax reasons 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 current 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) draws on language in Reg. § 20.2056(b)-5(f)(4) and (5) to enable a trust for a spouse to qualify for a marital deduction if applicable state law is unclear about the spouse's right to compel the trustee to make property productive of income. The trustee should also consider the application of Section 401 of this Act and the provisions of Restatement of Trusts 3d: Prudent Investor Rule § 240, at 186, app. § 240, at 252 (1992). Example (6) in the Comment to Section 401 describes a situation involving the payment from income of carrying charges on unproductive real estate in which Section 401 may apply.

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 401(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 Section 813, the power under Section 401(a) would be exercised to transfer principal to income and not to transfer income to principal.

Section 813 does not apply to a so-called "estate" trust, which will qualify for the marital deduction, even though the income may be accumulated for a term of years or for the life of the surviving spouse, if the terms of the trust require the principal and undistributed income to be paid to the surviving spouse's estate when the spouse dies. Reg. § 20.2056(c)-2(b)(1)(iii).

SECTION 814. 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 group of assets.

(b) To the extent a trustee does not account under Section 803 for a transaction in derivatives, the trustee shall allocate to principal receipts from and disbursements made in connection with the transaction.

(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. 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.

Drafting Note: *This section could still benefit from the input of representatives of financial institutions who work with exotic financial instruments.*

Comment on 1997 Act

Scope and application. It is difficult to predict how frequently and to what extent 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 trust participates in derivatives indirectly through an entity, an amount received from the entity will be allocated under Section 801 and not Section 814. If a trustee invests directly in derivatives to a significant extent, the expectation is that receipts and disbursements related to derivatives will be accounted for under Section 803; if a trustee chooses not to account under Section 803, Section 814(b) provides the default rule. Certain types of option transactions in which trustees may engage are dealt with 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 set of objectives 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 814(a) is derived in part from the FASB definition. 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 803. 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 also require definition, and the definition in this Act 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 that is income or principal under the Act - only cash receipts and disbursements, and the receipt of property in exchange for a principal asset, affect a trust's principal and income accounts.

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 804(2).

Options. Options to which subsection (c) applies include an option to purchase real estate owned by the trustee and 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. Subsection (c) would also apply to a continuing and regular practice of selling call options on securities owned by the trust if the terms of the option require delivery of the securities. 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 815. ASSET-BACKED SECURITIES.

(a) In this section, "asset-backed security" means an asset whose value is based on 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 from the collateral financial assets only the interest or other current return or only the proceeds other than interest or current return. The term does not include an asset to which Section 801 or 809 applies.

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

(d) The percentage used under subsection (c) shall be 10 percent, unless the trustee selects a different percentage:

(1) in a policy adopted under Section 301 or

(2) by an action to change the percentage taken pursuant to the procedures in Section 301.

Drafting Note: *This section could still benefit from the input of representatives of financial institutions who work with exotic financial instruments.*

Comment on 1997 Act

Scope of section. Typical asset-backed securities include arrangements in which debt obligations such as real estate mortgages, credit card receivables and auto loans are acquired by an investment trust and interests in the trust are sold to investors. The source for payments to an investor is the money received from principal and interest payments on the underlying debt. An asset-backed security includes an "interest only" or a "principal only" security that permits the investor 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 a security that permits the investor to participate in either the capital appreciation of an underlying security or in the interest or dividend return from such a security, such as the "Primes" and "Scores" issued by Americus Trust. An asset-backed security does not include an interest in a corporation, partnership, or an investment trust described in the Comment to Section 802, whose assets consist significantly or entirely of investment assets. Receipts from an instrument that do not come within the scope of this section or any other section of the Act (including, under the current Act, Section 816) would be allocated entirely to principal under the rule in Section 103(a)(4), and the trustee may then consider whether and to what extent to exercise the power to adjust in Section 401, taking into account the return from the portfolio as whole and other relevant factors.

SECTION 816. OTHER FINANCIAL INSTRUMENTS AND ARRANGEMENTS.

A trustee shall allocate receipts from or related to financial instruments and arrangements not explicitly addressed by this [act] in a manner consistent with the rules proscribed and the principles reflected in Sections 814 and 815.

Comment

Section 816 is added to the current Act to provide guidance for financial instruments and arrangements designed in the future, which the Drafting Committee could not have anticipated and addressed explicitly.

[ARTICLE] 9

ALLOCATION OF DISBURSEMENTS DURING ADMINISTRATION OF TRUST

SECTION 901. DISBURSEMENTS FROM INCOME. A trustee shall make the following disbursements from income to the extent they are not disbursements to which Section 601(2)(B) or (C) applies:

(1) one-half of:

(A) the regular compensation of the trustee and of any person providing investment advisory or custodial services to the trustee; and

(B)all expenses for accountings, judicial and nonjudicial proceedings, or other matters that involve both the income and remainder interests;

(2) the balance of the disbursements described in paragraph (1) to the extent a trustee which is a disinterested person as defined in Section 501(a)(1) of this [act] determines that making those disbursements from income would be in the interests of the trust and its beneficiaries because principal is illiquid;

(3) all 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

Paying more than half of certain disbursements from income. Current Section 901(2) is added to be consistent with other parts of the Act, such as Section 103(a)(4) and (5), that favor principal when appropriate.

Comment to 1997 Act

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.

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 902(a)(5).

Regularly recurring taxes. The reference to "regularly recurring taxes assessed against principal" includes all taxes regularly imposed on real property and tangible and intangible personal property.

SECTION 902. DISBURSEMENTS FROM PRINCIPAL.

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

(1) the remaining one-half of the disbursements described in Section 901(1) after application of Section 901(2);

(2) all the trustee's compensation calculated on principal as a fee for acceptance, distribution, or termination, 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) premiums paid on a policy of insurance not described in Section 901(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 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 principal balance of the obligation.

Comment on 1997 Act

Environmental expenses. All environmental expenses are payable from principal, subject to the power of the trustee to transfer funds to principal from income under Section 904. However, the Drafting Committee decided that it was not necessary to broaden this provision to cover other expenditures made under compulsion of governmental authority. See generally 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).

Environmental expenses paid by a trust are to be paid from principal under Section 902(a)(7) on the assumption that they will usually 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 cleanup costs would be a normal cost of doing business and would be accounted for under Section 803. In accounting under that Section, environmental costs will be a factor in determining how much of the net receipts from the business is trust income. Paying all other environmental expenses from principal is consistent with this Act's approach regarding receipts - 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.

Under Sections 904(a) and 904(b)(5), a trustee who makes or expects to make a principal disbursement for an environmental expense described in Section 902(a)(7) is authorized to transfer an appropriate amount from income to principal to reimburse principal for disbursements made or to provide a reserve for future principal disbursements.

The first part of Section 902(a)(7) is based upon the definition of an "environmental remediation trust" in Treas. Reg. § 301.7701-4(e)(as amended in 1996). This is not because the

Act applies to an environmental remediation trust, but because 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. Disbursements that are made to protect a trust's property, referred to in Section 902(a)(4), include an "action to assure title" that is mentioned in Section 13(c)(2) of the 1962 Act.

Insurance premiums. Insurance premiums referred to in Section 902(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 provision in the 1962 Act for life insurance premiums.

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

SECTION 903. TRANSFERS FROM INCOME TO PRINCIPAL FOR DEPRECIATION.

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

(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 may not transfer any amount for depreciation:

(1) of the part 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 803 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 has 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, who do not provide for any depreciation for a variety of reasons. One reason relied upon is that a charge for depreciation is not needed to protect the remainder beneficiaries if the value of the land is increasing; 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 the decision to provide for depreciation should be discretionary with the trustee. The power to transfer funds from income to principal that is granted by this section is a discretionary power of administration referred to in Section 103(b), and in exercising the power a trustee must comply with 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 904(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 904. 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 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 tenant allowances, leasehold improvements, and broker's commissions;

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

(5) disbursements described in Section 902(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 904 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 904 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 principal payments on the mortgage.

SECTION 905. 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:

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

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

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

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

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

Comment

Marital deduction issues. Any payment of income tax from income could raise issues of the estate or gift tax marital deduction, especially if the income on which that income tax is paid is not fully distributed, as in the case of income retained in an entity owned in whole or in part by the trust. The Drafting Committee found these issues to be similar to the issues raised by Rev. Rul. 2006-26 in the context of defined contribution qualified retirement plans and individual retirement accounts (IRAs). The committee concluded that no change needs to be made to the Act because it understands that the power in the spouse to cause the trust assets to be made reasonably productive of income cures any marital deduction issue.

Comment to 1997 Act

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

Subsection (c) requires the trust to pay the taxes on its share of an entity's taxable income from income or principal receipts to the extent that receipts from the entity are allocable to each. This assures the trust a source of cash to pay some or all of the taxes on its share of the entity's taxable income. Subsection 905(d) recognizes that, except in the case of an Electing Small Business Trust (ESBT), a trust normally receives a deduction for amounts distributed to a beneficiary. Accordingly, subsection 905(d) requires the trust to increase receipts payable to a beneficiary as determined under subsection (c) to the extent the trust's taxes are reduced by distributing those receipts to the beneficiary.

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

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

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

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

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

D = Distribution to income beneficiary
C = Cash paid by the entity to the trust
R = tax rate on income
K = entity's K-1 taxable income

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

Taxable Income per K-1	1,000,000
Payment to beneficiary	230,769[1]
Trust Taxable Income	$ 769,231
35 percent tax	269,231

Partnership Distribution	$ 500,000
Trustee's Tax Liability	(269,231)
Payable to the Beneficiary	$ 230,769

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

If a trustee determines that it is appropriate to so, it should consider exercising the discretion granted in UPIA section 906 to adjust between income and principal. Alternatively, the trustee may exercise the power to adjust under UPIA section 401 to the extent it is available and appropriate under the circumstances, including whether a future distribution from the entity that would be allocated to principal should be reallocated to income because the current income beneficiary already bore the burden of taxes on the reinvested income. In exercising the power, the trust should consider the impact that future distributions will have on any current adjustments.

SECTION 906. ADJUSTMENTS BETWEEN INCOME AND PRINCIPAL BECAUSE OF TAXES.

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

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

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

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

(b) If the amount of an estate-tax marital deduction or charitable-contribution deduction is reduced because a trustee deducts an amount 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 a trust or beneficiary are decreased, each 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 the principal used to pay the increase would have qualified for a marital deduction or charitable contribution deduction but for the payment. The proportionate share of the reimbursement for each trust or beneficiary whose income taxes are reduced must be the same as its proportionate share of the total decrease in income tax. A trust shall reimburse principal from income.

Comment to 1997 Act

Discretionary adjustments. Section 906(a) permits the trustee to make adjustments between income and principal because of tax law provisions. It would permit discretionary adjustments in situations like these: (1) A trustee 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 a principal asset to a trust or other beneficiary causes the taxable income of an estate or trust to be carried out to the distributee and relieves the persons who receive the income 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 under applicable federal income tax rules the trustee may not deduct the state income tax payment from the capital gain in calculating the trust's federal capital gain tax, and the current income beneficiary receives the benefit of the deduction for state income tax paid on the capital gain. See generally Joel C. Dobris, Limits on the Doctrine of Equitable Adjustment in Sophisticated Postmortem Tax Planning, 66 Iowa L. Rev. 273 (1981).

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

Section 906(a)(3) applies to a qualified Subchapter S trust (QSST) whose current 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 current income beneficiary's tax liability, the trustee may distribute additional cash from principal to the current 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 sale 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 trustee 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 trustee'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 trustee 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 trustee 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 net benefit to the income beneficiaries will be $10,000.

Irrevocable grantor trusts. Under Sections 671-679 of the Internal Revenue Code (the "grantor trust" provisions), 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 settlor 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 require or authorize a trustee to distribute funds from the trust to the settlor in these cases because it is difficult to establish a rule that applies only to trusts where this tax result is unintended and does not apply to trusts where the tax result is intended. Settlors who intend this tax 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 settlor to reimburse the settlor 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 Internal Revenue Service may require that such a provision be placed in the terms of the trust as a condition to issuing a private letter ruling.

[ARTICLE] 10

MISCELLANEOUS PROVISIONS

SECTION 1001. UNIFORMITY OF APPLICATION AND CONSTRUCTION. In applying and construing this uniform act, consideration must be given to the need to promote uniformity of the law with respect to its subject matter among states that enact it.

[SECTION 1002. SEVERABILITY CLAUSE. 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.]

Legislative Note: *Include this section only if this state lacks a general severability statute or a decision by the highest court of this state stating a general rule of severability.*

SECTION 1003. REPEALS; CONFORMING AMENDMENTS.

(a) . . . .

(b) . . . .

(c) . . . .

SECTION 1004. APPLICATION OF [ACT] TO EXISTING TRUSTS AND ESTATES. This [act] applies to every trust or decedent's estate existing on [the effective date of this [act]] except as otherwise expressly provided in the terms of the trust or in this [act].

Alternative A

SECTION 1005. TRANSITIONAL MATTERS. Section 809, as amended by this [amendment], applies to a trust described in Section 809(d) on and after the following dates:

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

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

(3) If the trust is not described in paragraph (1) or (2), January 1, ______ [insert year in which this [amendment] take effect].

Alternative B

SECTION 1005. TRANSITIONAL MATTERS. Section 809 applies to a trust described in Section 809(d) on and after the following dates:

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

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

(3) If the trust is not described in paragraph (1) or (2), January 1, ______ [insert year in which this [act] takes effect].

End of Alternatives

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

If your state has not adopted the Uniform Principal and Income Act, use the text of Sections 809 and 905, as amended by these amendments, instead of the text of the previous version of those Sections.

SECTION 1006. EFFECTIVE DATE. This act takes effect . . . .