UNIFORM FIDUCIARY INCOME AND PRINCIPAL ACT

[FORMERLY REVISED UNIFORM PRINCIPAL AND INCOME ACT]

NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS

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November 5, 2017
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# UNIFORM FIDUCIARY INCOME AND PRINCIPAL ACT

## TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Description</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prefatory Note</td>
<td></td>
<td>1</td>
</tr>
<tr>
<td>[Article] 1</td>
<td>SHORT TITLE, DEFINITIONS, SCOPE, AND GOVERNING LAW</td>
<td></td>
</tr>
<tr>
<td>Section 101</td>
<td>SHORT TITLE</td>
<td>3</td>
</tr>
<tr>
<td>Section 102</td>
<td>DEFINITIONS</td>
<td>3</td>
</tr>
<tr>
<td>Section 103</td>
<td>SCOPE</td>
<td>10</td>
</tr>
<tr>
<td>Section 104</td>
<td>GOVERNING LAW</td>
<td>10</td>
</tr>
<tr>
<td>[Article] 2</td>
<td>FIDUCIARY DUTIES AND JUDICIAL REVIEW</td>
<td></td>
</tr>
<tr>
<td>Section 201</td>
<td>FIDUCIARY DUTIES; GENERAL PRINCIPLES</td>
<td>12</td>
</tr>
<tr>
<td>Section 202</td>
<td>JUDICIAL REVIEW OF DISCRETIONARY POWER</td>
<td>16</td>
</tr>
<tr>
<td>Section 203</td>
<td>FIDUCIARY’S POWER TO ADJUST</td>
<td>18</td>
</tr>
<tr>
<td>[Article] 3</td>
<td>UNITRUST</td>
<td></td>
</tr>
<tr>
<td>Section 301</td>
<td>DEFINITIONS</td>
<td>23</td>
</tr>
<tr>
<td>Section 302</td>
<td>APPLICATION OF [ARTICLE]</td>
<td>25</td>
</tr>
<tr>
<td>Section 303</td>
<td>AUTHORITY OF FIDUCIARY</td>
<td>26</td>
</tr>
<tr>
<td>Section 304</td>
<td>NOTICE</td>
<td>29</td>
</tr>
<tr>
<td>Section 305</td>
<td>UNITRUST POLICY</td>
<td>31</td>
</tr>
<tr>
<td>Section 306</td>
<td>UNITRUST RATE</td>
<td>32</td>
</tr>
<tr>
<td>Section 307</td>
<td>APPLICABLE VALUE</td>
<td>33</td>
</tr>
<tr>
<td>Section 308</td>
<td>PERIOD</td>
<td>34</td>
</tr>
<tr>
<td>Section 309</td>
<td>OTHER RULES; SPECIAL TAX BENEFITS</td>
<td>36</td>
</tr>
<tr>
<td>Section 310</td>
<td>DUTIES AND REMEDIES</td>
<td>36</td>
</tr>
</tbody>
</table>
[ARTICLE] 4

ALLOCATION OF RECEIPTS DURING ADMINISTRATION

[PART 1]

RECEIPTS FROM ENTITIES

SECTION 401. CHARACTER OF RECEIPTS ................................................................. 40
SECTION 402. DISTRIBUTION FROM TRUST OR ESTATE ........................................ 44
SECTION 403. BUSINESS AND OTHER ACTIVITIES CONDUCTED BY FIDUCIARY .... 44

[PART 2]

RECEIPTS NOT NORMALLY ALLOCATED

SECTION 404. PRINCIPAL RECEIPTS ........................................................................ 46
SECTION 405. RENTAL PROPERTY ............................................................................ 47
SECTION 406. RECEIPT ON AN OBLIGATION TO BE PAID IN MONEY .................. 47
SECTION 407. INSURANCE POLICIES AND SIMILAR CONTRACTS .......................... 48

[PART 3]

RECEIPTS NORMALLY APPORTIONED

SECTION 408. DEFERRED COMPENSATION, ANNUITIES, AND SIMILAR PAYMENTS .............................................................................................................. 48
SECTION 409. CERTAIN ILLIQUID ASSETS ................................................................ 51
SECTION 410. MINERALS, WATER, AND OTHER NATURAL RESOURCES ......... 52
SECTION 411. TIMBER ............................................................................................. 53
SECTION 412. MARITAL DEDUCTION PROPERTY NOT PRODUCTIVE OF INCOME .. 54
SECTION 413. DERIVATIVES AND OPTIONS .......................................................... 55
SECTION 414. ASSET-BACKED SECURITIES ......................................................... 56
SECTION 415. OTHER FINANCIAL INSTRUMENTS AND ARRANGEMENTS .......... 57
SECTION 416. INSUBSTANTIAL ALLOCATIONS NOT REQUIRED ....................... 57

[ARTICLE] 5

ALLOCATION OF DISBURSEMENTS DURING ADMINISTRATION

SECTION 501. DISBURSEMENTS FROM INCOME .................................................... 58
SECTION 502. DISBURSEMENTS FROM PRINCIPAL .............................................. 59
SECTION 503. TRANSFERS FROM INCOME TO PRINCIPAL FOR DEPRECIATION
SECTION 504. TRANSFERS FROM INCOME TO REIMBURSE PRINCIPAL
SECTION 505. INCOME TAXES
SECTION 506. ADJUSTMENTS BETWEEN INCOME AND PRINCIPAL BECAUSE OF TAXES

[ARTICLE] 6
DEATH OF DECEDEDNT OR TERMINATION OF INCOME INTEREST
SECTION 601. DETERMINATION AND DISTRIBUTION OF NET INCOME
SECTION 602. DISTRIBUTION TO RESIDUARY AND REMAINDER BENEFICIARIES

[ARTICLE] 7
APPORTIONMENT AT BEGINNING AND END OF INCOME INTEREST
SECTION 701. WHEN RIGHT TO INCOME BEGINS AND ENDS
SECTION 702. APPORTIONMENT OF RECEIPTS AND DISBURSEMENTS WHEN DECEDEDNT DIES OR INCOME INTEREST BEGINS
SECTION 703. APPORTIONMENT WHEN INCOME INTEREST ENDS

[ARTICLE] 8
MISCELLANEOUS PROVISIONS
SECTION 801. UNIFORMITY OF APPLICATION AND CONSTRUCTION
SECTION 802. APPLICATION OF [ACT] TO EXISTING TRUSTS AND ESTATES
SECTION 803. TRANSITIONAL MATTERS
SECTION 803. TRANSITIONAL MATTERS
SECTION 805. REPEALS; CONFORMING AMENDMENTS
SECTION 806. EFFECTIVE DATE
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 totally discretionary trusts -- that is, trusts in which income, as well as principal, is distributable to beneficiaries during the term of the trust less as a matter of right and more 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 supplement 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 standards for adjusting between income and principal that are reasonable in the circumstances, and to update those standards from time to time. Authority to make adjustments between income and principal from year to year, introduced as Section 104 in 1997, is retained, and indeed significantly expanded, as new Section 203. 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 203 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 could cope with the constraints of income and principal rules by merely accumulating income or invading principal now is given the alternative of making an adjustment under Section 203 instead, either from year to year, as under former Section 104, or for more than one year, under these expanded rules.
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 203, a trustee of a discretionary trust can make adjustments, taking into account a nonexclusive list of factors provided in Section 201(c), and still achieve the comfortable outcome of “distributing income.” And when the interests of beneficiaries under the terms of the trust are still not appropriately served within the framework of “distributing income” – that is, when no reasonable adjustment would serve those interests, or when significant 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 does not make adjustments under Section 203 still has the option of following the more traditional rules, which are retained, with modest updates, in Articles 4 through 7.

As perhaps the “ultimate adjustment,” Article 3 adds the authority for a trustee to convert a trust to a unitrust. This is discussed in the Comment to Article 3.

Finally, new Section 104 provides an important clarification that the income and principal rules of the state that is the principal place of administration of the trust from time to time will be the governing law.
UNIFORM FIDUCIARY INCOME AND PRINCIPAL ACT

[ARTICLE] 1

SHORT TITLE, DEFINITIONS, SCOPE, AND GOVERNING LAW

SECTION 101. SHORT TITLE. This [act] may be cited as the Uniform Fiduciary Income and Principal Act.

Comment

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

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 “Fiduciary,” the name emphasizes that the distinctions between income and principal are most likely to be relevant in the context of trusts and decedents’ estates, especially trusts 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 arrangements other than just trusts and decedents’ estates, such as legal life estates, where those arrangements share the long-term character and need for balancing of successive interests that is most commonly associated with trusts. But the primary applications of the Act will generally be in contexts marked by the role of a fiduciary.

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 fiduciary. 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:

(A) in the case of a trust, an income beneficiary, including a current income beneficiary, a remainder beneficiary, and any other successor beneficiary;

(B) in the case of an estate, an heir[, legatee,] and devisee;

(C) in the case of a life estate or term interest, a person that holds a life estate, a term interest, or a remainder or other interest following a life estate or term interest; and

(D) in the case of another arrangement or relationship, a person that holds an interest in property or may succeed to an interest in property.

(3) “Current income beneficiary” means a beneficiary to which a fiduciary may distribute net income, regardless of whether the fiduciary may also distribute principal to that beneficiary.

(4) Except in Section 401, “distribution” means payment or transfer by a fiduciary to a beneficiary in the beneficiary’s capacity as a beneficiary, made pursuant to the terms of the trust, without consideration other than a beneficiary’s right to receive a distribution under the terms of the trust. “Distribute” has a corresponding meaning.4

(5) “Estate” means a decedent’s estate. The term includes the property of the decedent as

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1 Paragraph (2) is broken into subparagraphs. Subparagraphs (C) and (D) are new.

2 “Person” is changed to “beneficiary” to create a better flow.

3 This is changed to the active voice. In addition, “net income of a trust” is changed to simply “net income.” This is the first of many rewrites to avoid the use of the word “trust,” in view of the expansion of the language throughout the Act from “trustee” to “fiduciary,” which includes personal representatives. It wasn’t possible in every case, and even this draft might go too far. The drafting committee should discuss this in the fall.

4 The second sentence had been “In Section 401, the term also includes a payment or transfer from an entity to an owner of the entity or another person with an interest in the entity.” This made the following sentence (the former third sentence, now the second sentence) regarding the corresponding meaning of “distribute” ambiguous. Did that third sentence of the paragraph refer to the first sentence, the second sentence, or both? Moreover, the deleted former second sentence was unnecessary. The words “distribution” and “distribute” are not used in Section 401 in the meaning given them by the first sentence of this paragraph. Therefore, Section 401 can have its own definition, which is added as Section 401(a)(1), with a conforming addition of “Except in Section 401,” at the beginning of this paragraph.
originally constituted and as it exists from time to time during administration.\(^5\)

(6) “Fiduciary” means a trustee, [trust director determined under [Section 2(9) of the Uniform Directed Trust Act,]\(^6\) personal representative, life tenant, holder of a term interest, or person acting under a legal delegation from a fiduciary. The term includes another person that holds property for a successor beneficiary whose interest may be affected by the allocation of receipts and expenditures between income and principal.\(^7\) If there are two or more co-fiduciaries, the term means all co-fiduciaries acting in accordance with the terms of the trust and applicable law, including this [act].

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

(8) “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 fiduciary’s discretion. The term also includes the right of a current beneficiary to use property held by a fiduciary.\(^8\)

(9) “Independent person” means a person that is not:

1. in the case of a trust:

---

\(^5\) The definition of “estate” in paragraph (5) is adapted from the UPC.

\(^6\) [NEW 11/1/17] In view of the ULC’s approval of UDTA, this reference to “trust director” in Section 102(6) is new, as well as the words “person acting under a legal delegation from a fiduciary” at the end of the sentence and the first sentence of the Legislative Note at the end of Section 102.

\(^7\) The phrase “whether the [fiduciary] also has a beneficial interest in the property” is deleted from paragraph (6) as redundant.

\(^8\) This sentence (“The term also includes the right of a current beneficiary to use property held by a fiduciary.”) is new and might be unnecessary and/or confusing. It is not a natural understanding of the term “income interest,” but something like this might be needed to complete the notion of “beneficiary” and “fiduciary” in paragraphs (2) and (6) and the intended scope for the Act we have described in Section 103.
(i) [a qualified beneficiary determined under [Section 103(13) of the Uniform Trust Code]] [a beneficiary that receives or is entitled to receive income from the trust or would be entitled to receive a distribution of principal if the trust were terminated, assuming no power of appointment is exercised];

(ii) a settlor of the trust or the spouse of a settlor of the trust; or

(iii) an individual whose legal obligation to support a beneficiary may be satisfied by distributions from the trust;

(B) in the case of an estate, a beneficiary;

(C) a parent, brother, sister, or issue of a person defined in subparagraph (A) or (B);

(D) a corporate, partnership, or other entity in which persons defined in subparagraphs (A) through (C), in the aggregate, have voting control; or

(E) an employee of a person defined in subparagraph (A), (B), (C), or (D).9

(10) “Mandatory income interest” means the right of a current income beneficiary to receive net income that the terms of the trust require the fiduciary to distribute.

(11) “Net income” means the total allocations to income under this [act] and the terms of the trust during an accounting period minus the disbursements, other than distributions, allocated

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9 [NEW 11/1/17] This new formulation in Section 102(9)(C), (D), and (E) replaces “a related or subordinate party with respect to a person defined in subparagraph (A) or (B)” that had been subparagraph (C). Generally, this tracks the definition of “related or subordinate party” in section 672(c) of the Internal Revenue Code, except that it uses the simpler term “voting control” instead of the more subjective “significant from the standpoint of voting control.” (The drafting committee might discuss whether that change leaves a gap that could create a tax trap for persons who rely on this provision.) With this change, the clunky definition of “related or subordinate party” that was Section 102(16) is deleted. That term, defined in Section 102(16), was not used in this draft anywhere else but in Section 102(9)(C) anyway.

As rewritten, in generalized and simplified terms, this Section 102(9) is a self-contained description of persons whom we don’t want to exercise powers to affect beneficial interests. That includes, for purposes of this Act, the general power to adjust in Section 203 and the specialized power to reallocate the apportionment of trust and estate
to income under this [act] and the terms of the trust during the period. The term includes adjustments from principal to income and excludes adjustments from income to principal under Section 203. If the trust is a unitrust or has been converted to a unitrust, the term includes the unitrust amount determined under [Article] 3.

(12) “Person” means an individual, estate, trust, business or nonprofit entity, public corporation, government or governmental subdivision, agency, or instrumentality, or other legal entity.

(13) “Personal representative” means an executor, administrator, successor personal representative, special administrator, and person who performs substantially the same function with respect to an estate under the law governing the person’s status.10

(14) “Principal” means property held in trust for distribution to, production of income for, or use by a current or successor beneficiary.

(15) “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.

(16) “Successor beneficiary” means a person entitled to receive income or principal or use property when an income interest or other current interest ends.

(17) “Terms of the trust”11 means the manifestation of the intent of a settlor or decedent with respect to a trust, expressed in a manner that admits of its proof in a judicial proceeding.

10 This definition of “personal representative” is adapted from the UPC. (“Personal representative,” not “executor,” is the term used in the UPC.) The words “with respect to an estate” (which is defined as “a decedent’s estate”) are added. The word “includes” is changed to “means,” to exclude other arrangements like “bankruptcy estates,” although the provisions of the Act could apply to a bankruptcy estate if it meets the requirements for “another arrangement or relationship” in Section 103.
whether by words in a record, by other written or spoken words, or by conduct. In the case of an
estate, the term includes a will. In the case of a life estate, term interest, or other arrangement or
relationship, the term includes the corresponding manifestation of the rights of the beneficiaries.

(18) “Trust”:

(A) includes:

(i) an express trust, private or charitable, with additions to the trust, wherever and however created; and

(ii) a trust created or determined by judgment or decree under which the trust is to be administered in the manner of an express trust; and

(B) excludes:

(i) a constructive trust;

(ii) a resulting trust, conservatorship, multi-party account, custodial arrangement for a minor, business trust, common trust fund, voting trust, security arrangement, liquidation trust, and trust for the primary purpose of paying debts, dividends, interest, salaries, wages, profits, pensions, retirement benefits, or employee benefits of any kind; and

(iii) an arrangement under which a person is a nominee, escrowee, or agent for another.

(19) “Trustee” includes an original, additional, or successor trustee, whether or not

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1 The defined term in paragraph (18) continues to be “terms of the trust,” which is used 20 times in the 2008 UPIA and 40 times in the UTC. “Terms of a trust” is used only four times in the 2008 UPIA, only 16 times in the UTC, and not at all in this draft.

12 Here in paragraph (18), and in a few other places in the previous draft, the term “decedent’s estate” was used. “Estate” is defined as “a decedent’s estate” in Section 102(5), making the use of “decedent’s” redundant, and it has been removed throughout the draft.

13 [NEW 11/1/17] the word “agent” is added to Section 102(18)(B)(iii) at Bill LaPiana’s suggestion.

14 This definition is adapted from the UPC. (Ironically, the UTC does not have a definition of “trust.”) It seems appropriate and might allay some of the concerns that “fiduciary” is too broad a term.
appointed or confirmed by a court.

(20) “Will” means any testamentary instrument recognized by applicable law that makes a legally effective disposition of a person’s property effective at that person’s death. The term includes a codicil.15

Legislative Note: Modify Section 102(6) to refer to Section 2(9) of the Uniform Directed Trust Act, or modify that provision appropriately if your state has not adopted the Uniform Directed Trust Act. Modify Section 102(9)(A)(i) to refer to Section 103(13) of the Uniform Trust Code, or modify that provision appropriately if your state has not adopted the Uniform Trust Code.

Comment

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

Income beneficiaries. The definitions of current income beneficiary (Section 102(3)) and income interest (Section 102(8)) 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).

“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 modern 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

15 [NEW 11/1/17] This definition of “will,” new in the last draft, is revised to avoid saying “‘Will’ means a … will ....”
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 contrast to “terms of a trust”) in the current Act because in context that
phrase is used much more often in the text of the Act.

SECTION 103. SCOPE. Except as otherwise provided in this [act] or in the terms of
the trust, this [act] applies to:

(1) a trust or estate;

(2) a life estate or other term interest in which the interests of one or more persons will be
succeeded by the interests of one or more other persons; and

(3) another arrangement or relationship to the extent a person holds property for the
benefit of a person that may succeed to an interest in the property, if the interests of the successor
may be affected by the allocation of receipts and disbursements between income and principal.

SECTION 104. GOVERNING LAW. Except as otherwise provided in this [act] or in
the terms of the trust, this [act] applies when this state is the principal place of administration of
an estate or trust or the situs of property not held in an estate or 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 of a trust to this state, the trustee submits to the application of
this [act] to any matter within its scope involving the trust.16

16 The first sentence of Section 104 formerly stated: “This [act] contains rules governing the administration of trusts
within its scope, not rules of construction.” John Langbein pointed out that this is not true: income and principal
allocations can determine who gets what, which is construction. The Comment to Section 104 acknowledges that
Section 104 is written this way despite that fact. The words “or the situs of property not held in an estate or trust”
are added to the first sentence to accommodate life estates and other relationships that are not trusts or estates.
The words “Except as otherwise provided in this [act] or in the terms of the trust,” are added at the beginning at the
suggestion of a Commissioner at the San Diego meeting. The draft is silent, however, on subsidiary issues such as
whether the governing instrument can designate the law of a jurisdiction with which the trust has little or no nexus or
contact.
Comment

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, often with appropriate savings provisions for tax benefits, etc. if the situs is changed. Authorities seem to be divided, however, 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 the fact that income and principal allocations often do determine who gets what and therefore have the effect of rules of construction, treating those allocations as governed by the place of current 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 (Treasury 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 104 clarifies that the Uniform Fiduciary Income and Principal Act, like a rule of administration, is governed by the law of the situs, or principal place of administration, of the trust, which is not necessarily the place where all or most or any of the trust assets are located.

A Commissioner also suggested that we deal with the case where a trust administered in one state owns property located in another state. That seems unnecessary. But the clause “which is not necessarily the place where all or most or any of the trust assets are located” is added at the end of the Comment to address that concern.
FIDUCIARY DUTIES AND JUDICIAL REVIEW

SECTION 201. FIDUCIARY DUTIES; GENERAL PRINCIPLES.

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

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

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

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

(4) shall add a receipt to principal to the extent neither the terms of the trust or the will nor this [act] allocates the receipt to income or principal or between income and principal;

and

(5) shall charge a disbursement to income to the extent neither the terms of the trust or the will nor this [act] allocates the disbursement to income or principal or between income and principal.

(b) In exercising the power to adjust under Section 203(a), the power to convert to or from a unitrust or change the administration of a unitrust under [Article] 3, or another 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,\(^1\) based on what is fair and reasonable to all the beneficiaries, giving due regard to the beneficiaries’ respective interests,\(^2\) except to the extent the terms of the trust manifest an intention that the trustee shall or may favor one or more beneficiaries.\(^3\)

(c) In deciding whether and to what extent to exercise powers under Section 203 and [Article] 3, a fiduciary 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;\(^4\)
5. the needs of the trust and the beneficiaries for liquidity and regularity of income;
6. the desirability of the preservation and appreciation of the capital of the trust,

\(^1\) Throughout Section 201(a), the words “or the will” are added to make it less awkward.

\(^2\) Although the use of “impartially” was questioned by the drafting committee, particularly by Carlyn, for being too subjective, section 803 of the UTC states simply that “[i]f a trust has two or more beneficiaries, the trustee shall act impartially in investing, managing, and distributing the trust property, giving due regard to the beneficiaries’ respective interests.”

\(^3\) The phrase “relationships to each other” has been deleted from Section 201(b). To the extent those relationships — for example, the fact that a surviving spouse with a life income interest is (or is not) the parent of the decedent’s children — are relevant, they are incorporated in the phrase “the beneficiaries’ respective interests.”

\(^4\) John Langbein believed that this exception was too restrictive. In response, “clearly manifest” (which seems redundant) is changed to simply “manifest,” which might help. John also suggested replacing “terms of the trust” with something like “logic of the trust” to pick up notions such as a preference for taking care of a surviving spouse. Section 102(17) defines “terms of the trust” with reference to “written or spoken words or by conduct,” which arguably is broad enough.

\(^4\) With respect to “the identity and circumstances of the beneficiaries” identified as a potentially relevant factor in Section 201(c)(4), the drafting committee has discussed, for example, whether a fiduciary might or should be more comfortable with an adjustment between the current income interest of a surviving spouse and the successive interests of children if the spouse is also the parent of those children. Not dispositive, of course, but could it sometimes be at least relevant?
including the reasonable maintenance of the value of capital with regard to indices\textsuperscript{22} the fiduciary
determines to be appropriate;\textsuperscript{23}

(7) the role of allocations between income and principal in enabling the fiduciary
to comply with subsection (b) after applying the rules in subsection (a);

(8) the assets held in the trust, the extent to which the assets 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] 4 through 7, the
extent to which an asset is used or may be used by a beneficiary, and whether an asset was
purchased by the fiduciary or received from the settlor;

(9) the net amount that would be allocated to income under [Articles] 4 through 7
to the extent they apply;

(10) the suitability of the rules in [Articles] 4 through 7 in the context of all the
relevant factors considered by the fiduciary, including the other factors in this subsection to the
extent they are relevant;\textsuperscript{24}

(11) the increase or decrease in the value of principal assets, which the fiduciary

\textsuperscript{22}[NEW 11/1/17] In the previous draft, what is now just “indices” in Section 201(c)(6) was “the cost of living and
other indices.” Members of the drafting committee expressed uneasiness with the notion that a fiduciary is expected
to match any specific index. But that is not necessarily the result from allowing the fiduciary to keep an eye on
indices of its choosing. A fiduciary might conclude, for example, that if the growth of the principal in any year (or a
smoothed average of more than one year) is less than one half of the growth in a given index or blend of indices,
consideration should be given (not necessarily conclusively) to making an adjustment.

\textsuperscript{23}This factor in paragraph (6), relating to the preservation of capital, which the drafting committee seemed to view
as paramount in Chicago last September, was changed to just one of many factors after the discussion in Washington
in March. The concern that many expressed in March about the role of cost-of-living indices might be addressed
somewhat by the replacement of “measured by” with “with regard to.” The most recent change of “need” to
“desirability” at the beginning of paragraph (6) may further soften the articulation of this factor.

\textsuperscript{24}[NEW 11/117] Members of the drafting committee discussed in a conference call the desirability of trying to
distinguish between use of the power to adjust “generally” and use of the power to correct problems caused by the
default rules. Because the adjustment itself is the same in either case, it could be complicating to attempt to carry out
that desire in that way. But the new factor in Section 201(c)(10) is intended to address that concern.
may estimate as to an asset for which market value is not readily available;

(12) whether and to what extent the terms of the trust give the fiduciary power to accumulate income or invade principal or prohibit the fiduciary from accumulating income or invading principal;

(13) the extent to which the fiduciary has accumulated income or invaded principal;

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

(15) the anticipated tax consequences of exercising the powers.

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 501(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 those 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. Among other things, this could make relevant the relationships of beneficiaries to each other, 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.
Factors. The factors in Section 201(c) 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 203.

Section 201(c)(8), based on former Section 104(b)(5), includes “whether an asset was purchased by the fiduciary or received from the settlor” as a factor to consider. This acknowledges the special status historically accorded to “inception assets” that are contributed to a 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 may 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.

SECTION 202. JUDICIAL REVIEW OF DISCRETIONARY POWER.²⁵

(a) The court may not order a fiduciary to change a decision to exercise or not to exercise a discretionary power conferred by this [act] unless the court determines that the decision was an abuse of the fiduciary’s discretion. A fiduciary’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.

(b) If the court determines that a fiduciary has abused the fiduciary’s discretion, the court may place the income and remainder beneficiaries in the positions they would have occupied if the discretion had not been abused, under the following rules:

²⁵ [NEW 11/1/17] Many discussions, including past drafting committee meetings and recent conference calls, suggest that Section 202 needs more attention and, in particular, needs to be rationalized in comparison to Sections 201 (regarding general principles of fiduciary duty), 203(j) (regarding the power to adjust), and 310 (regarding the power to convert to a unitrust). Section 202 throughout uses a standard of “abuse of the fiduciary’s discretion,” whereas Sections 203(j) and 310, and even Section 201(a)(1) itself, as well as Section 801 of the Uniform Trust Code, cite “good faith.” Section 202(b) is uncharacteristically detailed (compared, for example, to the very general list in UTC Section 1001(b)(1) through (9), coupled with the “other appropriate relief” catch-all of Section 1001(b)(10)). But some might view Section 202(b) as uncharacteristically narrow in its focus on distributions. Perhaps distributions are the only things that could ever be affected by an abuse of discretion under UFIPA, but can we be sure? What if a trustee uses creative applications of the special default rules in Article 4 to cover up a failure to invest prudently for total return? Or what if improper distorted outcomes under Article 4 simply lull the trustee into even a good faith (to that extent) belief that its investments are prudent when they are not?

The drafting committee might also want to consider if there are any differences between Sections 203(j) and 310 themselves that need reconciling, such as the additional words “regardless of whether the affected person received notice in a record as provided in this [article] or the affected person was under a legal disability at the time of delivery of the notice” in Section 310.
(1) To the extent the abuse of discretion resulted in no distribution to a beneficiary or in a distribution that is too small, the court shall order the fiduciary to distribute to the beneficiary an amount the court determines will restore the beneficiary, in whole or in part, to the beneficiary’s appropriate position.

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

(3) To the extent that the court is unable, after applying paragraphs (1) and (2), to place the beneficiaries, the trust, or both, in the positions they would have occupied if the discretion had not been abused, the court may order the fiduciary to pay an appropriate amount from the fiduciary’s own funds to one or more of the beneficiaries, the trust, or both.26

(c) On [petition] by the fiduciary, the court having jurisdiction over a trust shall determine whether a proposed exercise or nonexercise by the fiduciary of a discretionary power conferred by this [act] will result in an abuse of the fiduciary’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 fiduciary relies, and an

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26 This subsection (b) was reinstated at the request of the drafting committee in March. But the special rules in Section 203(j) for the power to adjust and Section 310(b) for unitrust conversions are narrower than this, especially in their protection of the fiduciary from personal liability, and may therefore conflict with this. In November the drafting committee should consider this possibility of a conflict and resolve the conflict if one exists.

In addition, a Commissioner in San Diego suggested adding a reference to lost interest or lost purchasing power to paragraph (1); Turney replied that he wouldn’t want to presume to tell a court exactly what to do. In the context of subsection (c), a Commissioner asked us to think about attorney’s fees – reimbursing a successful challenger or charging an unsuccessful challenger. These suggestions are also an invitation for us to consider whether subsections (b) and (c) either conflict or overlap with each other or with Sections 203(j) and 310(b), as well as to return to the question of whether there is too much micromanagement of the court’s equitable power here.
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.

(d) A determination under this [act] is presumed to be fair and reasonable to all the beneficiaries. 27

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

|SECTION 203. FIDUCIARY’S POWER TO ADJUST. 28|

(a) A fiduciary may, without court approval, adjust between income and principal. 29

(b) In deciding whether and to what extent to exercise the power conferred by subsection (a), a fiduciary shall consider all factors relevant to the trust and its beneficiaries, including the relevant factors in Section 201(c).

(c) A fiduciary may not make an adjustment:

(1) that reduces the income interest in a trust that requires income to be paid at least annually to a spouse and for which a marital deduction for federal estate or gift tax purposes has been allowed, has been claimed, or could be claimed; 30

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27 This subsection is moved here from Section 103, which is now Section 201. A Commissioner in San Diego asked whether “determination” should be changed to “decision by a trustee,” and commented that this should be a “presumption affecting the burden of going forward with the evidence, and not the burden of proof.” In any event, the reference to “[act]” may not make sense, and this subsection may need some work.

28 In March this was expected to be Section 301, but dividing Article 3 into two parts just didn’t work very well.

29 [NEW 11/1/17] Earlier drafts have intentionally discarded the narrow preconditions for adjustments in the 1997 Act, including distributions defined with reference to income. It was hard to understand that precondition anyway when one of the potential “factors” (Section 104(b)(7) of the 1997 Act, now reflected in Section 201(c)(12) and (13) of this draft) is “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.” There is anecdotal evidence that as a precondition this provision is not strictly observed.

30 [NEW 11/1/17] In Section 203(c)(1), relating to the federal estate or gift tax marital deduction, “has been allowed, has been claimed, or could be claimed” replaces “would be allowed, in whole or in part, if the fiduciary did not have the power to make the adjustment.” This is much more direct, objective, and, indeed, factual. The trustee should
that reduces the actuarial value of a beneficiary’s income interest in a trust to
which a person transferred property if the transfer qualified or could qualify, in whole or in part,
for a federal gift tax exclusion based on the actuarial value of the income interest; 31
(3) that changes the amount payable to a beneficiary as a fixed annuity or a fixed
fraction of the value of the trust assets under the terms of the trust; 32
(4) from any amount that is permanently set aside for charitable purposes under
the terms of the trust unless both income and principal are set aside for charitable purposes;
(5) if possessing or exercising the power to make the adjustment causes a person
to be treated as the owner of all or part of the trust for federal income tax purposes, and the
individual would not be treated as the owner if the fiduciary did not possess the power to make
an adjustment;
(6) if possessing or exercising the power to make the adjustment causes all or part
of the value of the trust assets to be included for federal estate tax purposes in the gross estate of
know if a marital deduction has been allowed or claimed. This is not a long-term trust; the reference to income paid
to the spouse limits the effect of this provision to the spouse’s life (although the drafting committee may wish to
discuss whether that is too subtle and should be made more explicit). Both “allowed” and “claimed” are used to
make it clear that this provision applies even if the estate tax or gift tax return has not been audited and/or the statute
of limitation has not run. And “could be claimed” is added to make sure that the provision applies to any marital
trust even before the return is filed.
31 [NEW 11/1/17] In Section 203(c)(2), relating to the gift tax annual exclusion, “transfers” is changed to
“transferred” and “would qualify” is changed to “qualified or could qualify.” The reasons are very much the same as
those set forth in the preceding footnote. As a practical matter, while the allowance of an annual exclusion for the
actuarial value of an income interest is still allowed (see Treasury Reg. §25.2503-3), the practice has probably
become less common, as donors are more likely to elect to cover transfers to trusts with Crummey withdrawal
powers or forgo the annual exclusion for large gifts. Finally, “the actuarial value of the income interest” is changed
to “the actuarial value of a beneficiary’s income interest” to limit the application of this provision to the income
beneficiary’s life, as in Section 203(c)(1).
32 [NEW 11/1/17] It may not be self-evident how an exercise of the power to adjust could “[change] the amount
payable to a beneficiary as a fixed annuity or a fixed fraction of the value of the trust assets under the terms of the
trust” as Section 203(c)(3) provides. But, as Jim Gamble wrote in the Comments to the 1997 Act, subsection (c)(3)’s
“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 [then] Section 104(a).” The drafting committee may well decide not
to second-guess Jim’s conservatism.
an individual who has the power to remove a fiduciary or appoint a fiduciary, or both, and the
value of the assets would not be included in the gross estate of the individual if the fiduciary did
not possess the power to make the adjustment;

(7) if the trust is an irrevocable lifetime trust that provides income to be paid for
life to the settlor, and possessing or exercising the power to make an adjustment would cause any
public benefit program to consider the adjusted principal or income to be an available resource or
available income and the principal or income or both would in each case not be considered as an
available resource or income if the fiduciary did not possess the power to make an adjustment;\[NEW 11/1/17\]

(8) if the fiduciary is a beneficiary of the trust whose interest would be materially
affected by the adjustment;\[NEW 11/1/17\]

(9) if the fiduciary is not an independent person;\[NEW 11/1/17\]; or

(10) if the trust is a unitrust under [Article] 3.

(d) If subsection (c)(5), (6), (7), (8), or (9) applies to a fiduciary and there is more than
one fiduciary, a co-fiduciary to whom the provision does not apply may make the adjustment
unless the exercise of the power by the remaining fiduciary or fiduciaries is not permitted by the
terms of the trust.\[NEW 11/1/17\]

33 [NEW 11/1/17] New Section 203(c)(7) is an adaptation of New York’s EPTL § 11-2.3(b)(5)(C)(viii). Questions are (1) whether it’s a good idea; (2) whether it needs to be so detailed; (3) whether the wording is otherwise appropriate; and (4) whether it should be limited to trusts for settlors.

34 [NEW 11/1/17] An “independent person” is defined in Section 102(9)(A)(i) and (B) to include a beneficiary. Thus, it is hard to tell what Section 203(c)(8) adds to Section 203(c)(9).

35 The change to paragraph (9) eliminates the former subjective test of “whose interest would be materially affected” and also eliminates the dilemma that a trustee’s compensation could be increased by an adjustment between income and principal. “Independent person” is defined in Section 102(9) as basically someone who is not either a qualified beneficiary or someone related or subordinate to a qualified beneficiary.

36 [NEW 11/1/17] If Section 203(c)(5) or (6) applies because the fiduciary’s possession or exercise of the power to adjust would have unwelcome tax consequences for the fiduciary (probably not very likely if the fiduciary must be an independent person to exercise that power), or if the fiduciary is not an independent person, then Section 203(d) provides for a qualified co-fiduciary to exercise the power. But there is no explicit provision for appointment of
(e) A fiduciary 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 fiduciary 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 fiduciary 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 or the lives or more than one individual.37

(f) Terms of the trust that limit the power of a fiduciary 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 fiduciary the power of adjustment under subsection (a).

(g) The power of adjustment under subsection (a):

(1) may be exercised at or after the end of the accounting period or at or before the beginning of the accounting period; and

(2) may apply to the current accounting period or the immediately past accounting period and to one or more subsequent accounting periods.38

(h) A fiduciary’s exercise of the power under subsection (a) must be:

(1) included in the report, if any, that is sent to beneficiaries under [Section

37 A Commissioner in San Diego suggested adding these words “or the lives or more than one individual,” which makes sense.

38 [NEW 11/1/17] This revision of Section 203(g)(2) will prevent purported application to long closed accounting periods, which was not intended.
813(c)] of [the Uniform Trust Code]; or

(2) reported at least annually to [the qualified beneficiaries determined under

[Section 103(13)] of [the Uniform Trust Code], 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].

(i) This section does not create or imply a duty to exercise the power to adjust under

subsection (a) or to inform beneficiaries about the applicability of this section.39

(j) A fiduciary 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 fiduciary’s good-faith action or inaction under this section is to obtain a court order directing

the fiduciary to exercise or refrain from exercising the power of adjustment under this section.40

**Legislative Note:** Modify Section 203(h)(1) to refer to Section 813(c) of the Uniform Trust Code

and modify Section 203(h)(2) to refer to Section 103(13) of the Uniform Trust Code, or modify

those provisions appropriately if your state has not adopted the Uniform Trust Code.

**Comment [NOT UP-TO-DATE]**

**Limitations on the power to adjust.** Section 203(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, 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 trust terminates. Section 203(c)(8) uses the word “materially” for

that reason.

Section 203 does not provide for the appointment of a disinterested person to exercise the

power to adjust if no trustee is eligible, as Section 303(e) does in the case of converting the trust

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39 [NEW 11/1/17] The words “to exercise the power” are added to Section 203(i) to be consistent with the rest of the

section.

40 As stated in the footnote to Section 202(b), this narrower provision may conflict with Section 202(b). A

Commissioner in San Diego asked how this applies to actions that are prohibited under subsection (c).
to a unitrust, for example. Unlike a one-time conversion to a unitrust, 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 203(d) allows an adjustment to be made by a qualified co-trustee or
c​o-trustees when the other co-trustee or co-trustees is or are disqualified. 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.

Even in a case where Section 203(c) does not prohibit a trustee from adjusting between
income and principal because certain tax advantages might be jeopardized, the trustee’s
adjustment between income and principal 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” for income tax purposes.

[ARTICLE] 3

UNITRUST

SECTION 301. DEFINITIONS. In this [article]:

(1) “Applicable value” means the amount of the net fair market value of a trust taken into
account under Section 307.

(2) “Net fair market value of the trust” means the fair market value of the assets of the
trust, less the liabilities of the trust.

(3) “Special 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


41 [NEW 11/1/17] Article 3 generally addresses conversions of income trusts to unitrusts. Several states – apparently
including Alabama, Alaska, Arizona, Colorado, Delaware, Florida, North Carolina, Pennsylvania, South Carolina,
Tennessee, Vermont, West Virginia, and Wisconsin – have statutory provisions dealing with “express unitrusts” or
“express total return unitrusts,” which are trusts established to be either mandatory or elective unitrusts under the
terms of the trust. Should the uniform act do so as well? (It should not require a very elaborate addition.)

42 The word “Special” is added to “tax benefit” in paragraph (3).
2503(b)], as amended] because 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 as 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; or

(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.

(4) “Unitrust” means a trust:
(A) for which net income is a unitrust amount; and

(B) that meets the requirements of a unitrust policy.

(5) “Unitrust amount” means an amount computed by multiplying the applicable value by the unitrust rate.

(6) “Unitrust policy” means a policy described in Sections 305 through 309 and adopted under Section 303.

(7) “Unitrust rate” means the rate used to compute the unitrust amount under paragraph (5), determined pursuant to the unitrust policy.

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.

SECTION 302. APPLICATION OF [ARTICLE].

(a) This [article] applies to an estate only to the extent a trust is a beneficiary of the estate.43

(b) This [article] does not apply to a trust if:

(1) the terms of the trust expressly prohibit use of this [article] by a specific reference to this [article] or by an explicit expression of intent that income or 44 net income not be calculated as a unitrust amount; or

(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].45

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43 Section 302(a) is revised from a prohibition on estates to this limited permission.

44 The words “income or” are added to “net income” in Section 302(b)(1).

45 Section 302(b) formerly had an additional exception if a distributee had a power of withdrawal or a power to appoint trust funds to discharge his or her duty of support. The drafting committee criticized the general power (“5 and 5”) limitations, and perhaps no purpose is served by this exception at all. So it is removed from this draft.
(c) A trust may be converted to a unitrust under this [article] regardless of the terms of the trust concerning distributions. Conversion to a unitrust under this [article] does not affect other terms of the trust concerning distributions of income or principal.

**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.

**SECTION 303. AUTHORITY OF FIDUCIARY.**

(a) A fiduciary may, without court approval, convert a trust to a unitrust, discontinue the status of a trust as a unitrust,\(^46\) or change the percentage or method used to calculate the unitrust amount if:\(^47\)

1. the fiduciary adopts in a record a unitrust policy for the trust providing:

   (A) if the trust is not a unitrust:

   (i) that in administering the trust in the future the net income of the trust must be a unitrust amount rather than net income determined without regard to this [article];

and

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\(^{46}\) The description in Section 303(a) of the actions a trustee may take under this provision has been revised to eliminate any reference to “an income trust.”

\(^{47}\) [NEW 11/1/17] The former paragraph (1) of this Section 303(a) required the fiduciary to be an “independent person.” There seems to be no consensus reason for that limitation, and that paragraph is deleted from this draft. There is no consistency on this issue among states that have enacted unitrust statutes – some require the fiduciary to be independent with respect to the beneficiaries, while some even allow the beneficiaries themselves to convert to a unitrust without consent of the fiduciary. The plan is to provide a chart comparing the states at the November 17 drafting committee meeting. The revisions in this draft reflect the assumption that the drafting committee would ordinarily not want to prevent a conversion that some states now allow, including a conversion by the beneficiaries rather than the trustee. It is true that states that allow beneficiaries to convert to a unitrust generally require unanimous action of the beneficiaries – typically all the qualified beneficiaries – whereas the removal of the independent person requirement will appear to permit a fiduciary who is a beneficiary to unilaterally convert to a unitrust. But because the fiduciary under Section 304 must give notice to all qualified beneficiaries and under Section 303(a)(5) cannot proceed if any of them objects, the effect is equivalent to a requirement of unanimous consent. And in light of the removal of the requirement that the fiduciary be an independent person and the addition of the alternative authority in beneficiaries to convert to a unitrust, former subsections (d), (e), and (f), providing for options if the fiduciary is not an independent person, are deleted.
(ii) the percentage and method used to calculate the unitrust amount; or

(B) if the trust is a unitrust:

(i) that in administering the trust in the future the net income of the trust must be net income determined without regard to this [article] rather than a unitrust amount; or

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

(2) the fiduciary sends a notice described in Section 304;

(3) if the settlor of the trust is living, the fiduciary sends a copy of the notice required under paragraph (2) to the settlor;

(4) at least one member of each class[ of qualified beneficiaries] receiving the notice under paragraph (2) is:

(A) legally competent; [or]

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

[(C) represented in the manner provided in Section 304(b)]; and

(5) the fiduciary does not receive an objection in a record to the action proposed under this subsection from a person to whom the notice under paragraph (2) is sent by the date specified in the notice under Section 304(d)(4).

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48 This reference in Section 303(a)(5) to receiving “an objection in a record to the action proposed under this subsection from a person to whom the notice under paragraph (2) is sent” no longer includes the settlor, who now gets notice under the separate provisions of paragraph (3), not under paragraph (2). This is intended to eliminate any implication that the settlor must approve, or can veto, a unitrust conversion, which could create unwelcome tax results for the settlor, such as inclusion of the value of the trust assets in the settlor’s gross estate for estate tax purposes.
(b) If a fiduciary receives an objection in a record described in Section 304(d)(3) not later than the date stated in the notice under Section 304(d)(4), the fiduciary or a beneficiary may petition the court to have the proposed action taken as proposed, taken with modifications, or denied. A person described in Section 304(a) may oppose the action proposed under subsection (a) in the proceeding under this subsection, regardless of whether the person has:

(1) consented under Section 304(c); or

(2) objected under Section 304(d)(3).

(c) If a fiduciary decides not to take the action proposed under subsection (a), the fiduciary shall notify each person described in Section 304(a) of the decision not to take the action and the reasons for the decision.

(d) If a beneficiary requests a fiduciary to take the action described in subsection (a) and the fiduciary declines to do so or does not do so within 90 days of the fiduciary’s receipt of the request:

(1) [all the qualified beneficiaries determined under [Section 103(13)] of [the Uniform Trust Code], 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] may take the action described in subsection (a)(2); or

(2) a beneficiary may petition the court to direct the fiduciary to take action under subsection (a)(2).49

49 [NEW 11/1/17] Section 303(d) now gives the power to convert, alternatively, to qualified beneficiaries, and also confirms that any beneficiary can petition the court to convert. The selection of 90 days is arbitrary for now.
In deciding whether and how to take an action authorized by this section, or whether and how to respond to a request by a beneficiary under subsection (d) or a petition by a beneficiary under subsection (d)(2), a fiduciary shall consider all factors relevant to the trust and its beneficiaries, including the relevant factors in Section 201(c).

The fiduciary may release the power under subsection (a) for the reasons and in the manner described in Section 203(e).

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 Sections 303(a)(4) and 303(d)(1) to refer to Section 103(13) of the Uniform Trust Code, or modify those provisions appropriately if your state has not adopted the Uniform Trust Code.

SECTION 304. NOTICE.

(a) A notice required by Section 303(a)(2) must be sent in a manner authorized under [Section 109] of [the Uniform Trust Code] to:

(1) [the qualified beneficiaries determined under [Section 103(13)] of [the Uniform Trust Code], 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];

and

(2) [each person acting as trust director] of the trust under [the Uniform Directed Trust Act][each person that is granted a power over a trust by the terms of the trust to the extent the power is exercisable while the person is not then serving as a trustee:

50 [NEW 11/1/17] The words “or whether and how to respond to a request by a beneficiary under subsection (d) or a petition by a beneficiary under subsection (d)(2)” are added to Section 303(e) (Section 303(g) in the previous draft). Although beneficiaries are authorized under this draft to convert to a unitrust, it seems harsh to require persons who are not fiduciaries to consider factors that are designed to inform the exercise of fiduciary duty. Yet it seems appropriate that those factors be considered, and these additional words are intended to accomplish that.
(A) including a power over the investment, management, or distribution of

trust property or other matters of trust administration; and

(B) excluding a:

(i) power of appointment;

(ii) power to appoint or remove a trustee or person described in this

paragraph;

(iii) power of a beneficiary over a trust to the extent the exercise or

nonexercise of the power affects the beneficial interest of the beneficiary or another beneficiary

represented by the beneficiary under [Uniform Trust Code Sections 301 through 305] with

respect to the exercise or nonexercise of the power; and

(iv) power over a trust if the terms of the trust provide that the

power is held in a nonfiduciary capacity and the power must be held in a nonfiduciary capacity to

achieve the settlor’s tax objectives under the United States Internal Revenue Code of 1986[, as

amended][, and regulations issued thereunder]].

[(b) The representation provisions of [Article 3] of [the Uniform Trust Code] apply to

notice under this section.]51

[(c)] A notice under Section 303(a)(2) need not be sent to a person that consents in a

record to the action proposed under Section 303(a). The consent may be executed and delivered

at any time before, when, or after the proposed action is taken.

[(d)] A notice required by Section 303(a)(2) must include:

(1) notice of the action proposed under Section 303(a);

51 Section 304(a)(2) is adapted from Sections 2(5), 2(9), and 5(b) of the newly approved Uniform Directed Trust
Act. Corresponding additions are made to the Legislative Note at the end of Section 304.
(2) a copy of the unitrust policy under Section 303(a)(1);

(3) a statement that the person to which the notice is sent may object to the proposed action by stating the basis for the objection in a record and mailing or delivering the record to the fiduciary;\(^\text{52}\)

(4) the date by which an objection under paragraph (3) must be made, which must be at least 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;\(^\text{53}\)

(6) the name and mailing address\(^\text{54}\) of the fiduciary; and

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

**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 Section 304(a) to refer to Section 109 of the Uniform Trust Code or to appropriate general provisions for sending notice, modify Section 304(a)(1) to refer to Section 103(13) (defining “qualified beneficiary”) and related provisions of the Uniform Trust Code, modify Section 304(a)(2) to refer to Sections 301 through 305 of the Uniform Trust Code or replace it with a cross reference to the state’s law governing virtual representation, and modify the bracketed words in Section 304(b) to refer to Article 3 of the Uniform Trust Code; or modify those provisions appropriately if your state has not adopted the Uniform Trust Code. Modify Section 304(a)(2) to refer to the Uniform Directed Trust Act or modify that provision appropriately if your state has not adopted the Uniform Directed Trust Act.

**SECTION 305. UNITRUST POLICY.**

(a) In administering a unitrust under this [article], the fiduciary shall follow a unitrust policy adopted under Section 303(a)(1).

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\(^{52}\) This is revised in response to John Langbein’s urging that we “make it make sense.”

\(^{53}\) A Commissioner asked if we should require that the conversion or other change should be prospective only.

\(^{54}\) A Commissioner asked if we should accommodate email or other electronic “addresses,” pointing to the reference in paragraph (3) to “a record,” which is defined in Section 102(15) to include electronic media.
(b) A unitrust policy must provide for:

   (1) the unitrust rate or the determination of the unitrust rate under Section 306;

   and

   (2) the determination of the applicable value under Section 307.

SECTION 306. UNITRUST RATE.

(a) A unitrust rate may be:

   (1) a fixed unitrust rate; or

   (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.

(b) A unitrust policy may provide for:

   (1) a limit on how high the unitrust rate determined under subsection (a)(2) may

       rise;

   (2) a limit on how low the unitrust rate determined under subsection (a)(2) may

       fall;

   (3) a limit on how much the unitrust rate determined under subsection (a)(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;

   (4) a limit on how much the unitrust rate determined under subsection (a)(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; or
(5) a mathematical blend of any of the unitrust rates determined under subsection (a)(2) and paragraphs (1) through (4).

SECTION 307. APPLICABLE VALUE.

(a) A unitrust policy must state the method for determining the fair market value of an asset for purposes of determining the unitrust amount, including:

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

(2) the date for valuing an asset in each period in which the asset is valued.

(b) A unitrust policy may prescribe standards for:

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

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

(3) how the net income attributable to an asset to which paragraph (1) or (2) applies must be determined and the effect of the net income on distributions;\textsuperscript{55}

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

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

(c) A unitrust policy may prescribe methods for determining the amount of the fair market value to take into account in determining the applicable value, including:

\textsuperscript{55} Paragraph (3) formerly stated: “how the net income attributable to an asset excluded under paragraph (1) or given special treatment under paragraph (2) must be determined and the effect of the net income on distributions”. A
(1) use of an average of applicable values over a stated number of previous periods;

(2) use of another mathematical blend of applicable values over a stated number of previous periods;

(3) a limit on how much the applicable value of all assets, groups of assets, or individual assets, may increase over:

   (A) the corresponding applicable value for the previous period; or

   (B) a mathematical blend of applicable values over a stated number of previous periods;

(4) a limit on how much the applicable value of all assets, groups of assets, or individual assets may decrease below:

   (A) the corresponding applicable value for the previous period; or

   (B) a mathematical blend of applicable values over a stated number of previous periods; or

(5) the treatment of accrued income and other financial features of an asset.

(d) A unitrust policy may prescribe methods for determining the liabilities of the trust, including treatment of liabilities to conform with the treatment of assets under subsections (a) through (c).

SECTION 308. PERIOD.

(a) A unitrust policy must prescribe the period used under Section 306(a)(2) or 306(b)(3) or (4) or 307(a), which may be:

Commissioner in San Diego expressed concern with the word “special” because it is not used in paragraph (2). The result was the simpler articulation in paragraph (4) in this draft.
(1) a calendar year;
(2) a 12-month period other than a calendar year;
(3) a calendar quarter;
(4) a three-month period other than a calendar quarter; or
(5) another period;\(^6\)

(b) A unitrust policy may prescribe standards for:

(1) using a fewer number of previous periods under Section 306(a)(2)(B) or (b)(3) or (4) if the trust has not been in existence for the previous periods or market indices or other published data are not available;

(2) using a fewer number of previous periods under Section 307(c)(1), (2), (3)(B), or (4)(B) if:\(^7\)

(A) the trust has not been in existence for the previous periods; or

(B) fair market values are not available; or

(3) 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.

\(^{6}\) This clause in Section 308(a) formerly stated (with appropriate spacing and indenting): “which may be: (1) a calendar year or quarter; (2) a 12-month or three-month period other than a calendar year or quarter; or (3) another period.” Some Commissioners in San Diego, including a member of the Style Committee, suggested just saying “prescribe the period,” without specifically citing selected (perhaps arbitrarily selected) examples of a “period,” while acknowledging that setting forth the conventional periods might be helpful. But such a change might leave it ambiguous as to whether other than conventional periods are allowed, as well as sacrifice a bias for a conventional period unless there is a reason for the fiduciary to use a nonconventional period. The change in the current draft arguably goes in the opposite direction, converting three paragraphs into five. But that change may strengthen the protection against negative tax consequences, which should be a high priority of this draft in view of the Treasury Regulations already issued on this subject and described in the Comment after Section 310. See, for example, the change made to Section 309(c)(2). When a future draft is circulated to the Style Committee or the entire Commission, maybe more elaboration of the tax concerns would be a good idea.

\(^{7}\) A change from the previous draft is to break the second half of Section 308(b)(2) into two subparagraphs (A) and (B). This also may strengthen the tax protection. See the change to Section 309(c)(3).
SECTION 309. OTHER RULES; SPECIAL TAX BENEFITS.

(a) A unitrust policy may prescribe methods and standards for:

1. determining the timing of distributions;
2. making distributions in cash or in kind or partly in cash and partly in kind; or
3. correcting an underpayment or overpayment to a beneficiary based on the unitrust amount if there is an error in calculating the unitrust amount.

(b) A unitrust policy may prescribe other standards and rules the fiduciary determines serve the interests of the beneficiaries.

(c) If a trust qualifies for any special tax benefit:
1. the unitrust rate established under Section 306(a)(1) may not be less than three percent or more than five percent;
2. the only period that may be used under Section 308(a) is a calendar year under Section 308(a)(1);\(^\text{58}\) and
3. no other provision of Sections 306 through 308 applies, except Sections 307(a)(1), (b)(4) and (5), and (d) and 308(b)(2)(A) and (3).\(^\text{59}\)

SECTION 310. DUTIES AND REMEDIES.

(a) This [article] does not create or imply a duty to take action or to inform beneficiaries about the applicability of this [article].

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\(^{58}\) The words “under Section 308(a)(1)” are added to Section 309(c)(2) to make the tax protection even stronger. See the footnote to Section 308(a).

\(^{59}\) Section 309(c)(3) is cluttered, but it is the natural result of breaking up the former all-inclusive Section 501(o). In the previous draft Section 309(v)(3) stated: “no other provision of Sections 305 through 308 applies, except Sections 305(a), 307(a)(1), (b)(4) and (5), and (d), and 308(b)(2) and (3).” This draft removes Section 305, which doesn’t seem to fit, and limits the reference to Section 308(b)(2) to the newly bifurcated Section 308(b)(2)(A). See the footnote to Section 308(b)(2).
(b) A fiduciary that in good faith takes or fails to take any action under this [article] is not liable to a person affected by the action or inaction, regardless of whether the affected person received notice in a record as provided in this [article] 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 a fiduciary’s good-faith action or inaction under this [article] is to obtain a court order directing the fiduciary to convert a trust to a unitrust, discontinue the status of a trust as a unitrust, or change the percentage or method used to calculate the unitrust amount. 60

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.

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 a trust to a unitrust can provide a partnership among the income beneficiaries.

60 As stated in the footnote to Section 202(b), this narrower provision may conflict with Section 202(b).
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 203 and thus avoids or minimizes controversy over whether
such adjustments are proper.

By the end of 2016, 36 states\textsuperscript{61} (Alabama, Alaska, Arizona, California, Colorado,
Delaware, Florida, Georgia, Illinois, Indiana, Iowa, Kansas, Kentucky, Maine, Maryland,
Missouri, Nebraska, Nevada, New Hampshire, New Mexico, New York, North Carolina, Oregon,
Pennsylvania, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, 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 a trust to a unitrust. Some of those statutes refer to unitrusts as “total return unitrusts” (a
term not used in Article 3).

\textbf{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.

\textsuperscript{61} [NEW 11/1/17] The number of states (36) and list of those states are updated.
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.

**Article 3.** 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.” Article 3 borrows heavily from that existing 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 Article 3 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. Sections 305-308 allow 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 309(c)
limits the parameters in those situations to the parameters specified in that safe harbor. The
situations where Section 309(c) applies, described as situations in which the trust offers a
“special tax benefit” defined in Section 301(3), are limited to the situations addressed in the 2003
Treasury Regulations.

Because of the broad flexibility Article 3 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.

In addition to the requirements in Section 304(d), some state statutes also require the
trustee to send a copy of the state unitrust statute. If the other, somewhat more detailed,
requirements of this Article 3 are followed, that seems unnecessary, although any state that
chooses may still add it.

Section 302(c) 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.

[ARTICLE] 4

ALLOCATION OF RECEIPTS DURING ADMINISTRATION

[PART 1

RECEIPTS FROM ENTITIES]

SECTION 401. CHARACTER OF RECEIPTS.

(a) In this section:

(1) “Distribution” means a payment or transfer from an entity to an owner of the
entity or another person with an interest in the entity. “Distribute” has a corresponding
meaning.\(^{62}\)

(2) “Entity” means a corporation, partnership, limited liability company, regulated

\(^{62}\) Subsection (a)(1) is new and is explained in the footnote to Section 102(4). It may be that a better fix would have
been to find a different word or term altogether to replace “distribution,” but none came easily to mind.
investment company, real estate investment trust, common trust fund, or any other organization or arrangement in which a fiduciary has an interest, regardless of whether the entity is a taxpayer for federal income tax purposes, other than a trust or estate to which Section 402 applies, a business or activity to which Section 403 applies, an asset-backed security to which Section 414 applies, or an instrument or arrangement to which Section 415 applies.

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

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

1. property, of more than insubstantial 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 fiduciary’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 described in subparagraph (A)).

(d) In determining whether a distribution of money is received in partial liquidation of the entity, the following rules apply:

1. Money is not received in partial liquidation and is income to the extent it does not exceed the amount of income tax a fiduciary or beneficiary must pay on taxable income of

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63 This clause clarifies that “disregarded entities” (for tax purposes) are still entities under section 401, not under section 403. Maybe that policy choice should be discussed, but if a trustee who owns, say, a tree farm, wants to drop
the entity that distributes the money.

(2) If paragraph (1) does not apply, money is presumed to be received in partial liquidation to the extent the entity, not later than the date on which the entity files a federal income tax return for the year in which the distribution was made, indicates that it is a distribution in partial liquidation.\(^{65}\)

(3) If paragraph (1) does not apply and either paragraph (2) does not apply or the fiduciary does not know if paragraph (2) applies, money is presumed to be received in partial liquidation to the extent the distribution is attributable to the proceeds from a sale of a capital asset by the entity or by a subsidiary or affiliate of the entity.\(^{66}\)

(4) If paragraph (1) does not apply and either paragraphs (2) and (3) do not apply or the fiduciary does not know if paragraph (2) or (3) applies, money is presumed to be received in partial liquidation to the extent 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 fair market value\(^{67}\) of the entity’s assets, as shown by the entity’s year-end financial statements immediately preceding the initial distribution.\(^{68}\)

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\(^{64}\)[NEW 11/1/17] Paragraphs (2), (3), and (4) recite the condition “If paragraph (1) does not apply.” With reference to the application of paragraphs (2) and (3), paragraphs (3) and (4) add the alternative condition “the fiduciary does not know.” The reason for this difference is that presumably the fiduciary should know if paragraph (1) applies and should not be given the option of ignorance. But is that always true of a beneficiary’s income tax.

\(^{65}\)The clause “not later than the date on which the entity files a federal income tax return for the year in which the distribution was made” in Section 401(d)(2) replaces the less specific reference to “at or near the time of a distribution.”

\(^{66}\)[NEW 11/1/17] Section 401(d)(3), adapted from Section 16350(d) of the California Probate Code, was commended to the chairman and the reporter as a test that has proven workable in the context of sophisticated financial entities.

\(^{67}\)[NEW 11/1/17] In Section 401(d)(4), “fair market value” replaces “net value.” The drafting committee has discussed whether this standard is workable, but there has been no consensus about a replacement.

\(^{68}\)[NEW 11/1/17] The word “distribution” at the end of Section 401(d)(4) replaces the word “receipt.”
In applying paragraphs (2) through (4), a fiduciary may rely on information received from an entity and does not have a duty to inquiry or investigate unless:

(A) other information in the fiduciary’s possession indicates that the information received from the entity is or may be false, or

(B) the fiduciary owns at least 50 percent of the voting interest in the entity.

Comment

Additional flexibility. The references to Section 415 at the end of Section 401(a) and to entities comparably treated for federal income tax purposes in Section 401(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.

69 [NEW 11/1/17] Section 401(d)(5)(A) is intended to include John Langbein’s standard that “if something is smelly enough, the trustee should be able to use his nose.”

70 [NEW 11/1/17] It seems that one more paragraph or subsection is needed to provide an answer if none of the previous rules provide an answer. Letting a fiduciary just decide, with or without guidance such as a list of factors to consider, may put too much pressure on fiduciaries.

In the previous draft, subsections (d) through (g) stated:

(d) Money is presumed to be received in partial liquidation to the extent the entity, not later than the date on which the entity files a federal income tax return for the year in which the distribution was made, indicates that it is a distribution in partial liquidation. The fiduciary may determine that the circumstances require an allocation different from this presumption.

(e) If an entity does not indicate that a distribution is in partial liquidation and 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 fair market value of the entity’s assets, as shown by the entity’s year-end financial statements immediately preceding the initial receipt, the distribution shall be treated as a distribution in partial liquidation except to the extent the fiduciary determines the distribution is substantially equivalent to income previously undistributed.

(f) Money is not received in partial liquidation and is income to the extent it does not exceed the amount of income tax a fiduciary or beneficiary must pay on taxable income of the entity that distributes the money.

(g) A fiduciary may rely on a statement made by an entity about the source or character of a distribution if the statement is made not later than the date on which the entity files a federal income tax return for the year in which the distribution was made 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, including the manager of a limited liability company and general partner of a partnership.
SECTION 402. DISTRIBUTION FROM TRUST OR ESTATE. A fiduciary shall allocate to income an amount received as a distribution of income, including a unitrust distribution under [Article] 3,\textsuperscript{71} 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 fiduciary 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 fiduciary, Section 401 or 414 applies to a receipt from the trust.

SECTION 403. BUSINESS AND OTHER ACTIVITIES CONDUCTED BY FIDUCIARY.

(a) This section applies to a business or other activity conducted by a fiduciary if the fiduciary determines that it is in the best interest of the beneficiaries to account separately for the business or other activity instead of:

(1) accounting for the business or other activity as part of the fiduciary’s general accounting records; or

(2) conducting the business or other activity through an entity described in Section 401, whether or not the entity is a taxpayer for federal income tax purposes.

(b) A fiduciary that accounts separately for a business or other activity under this section may\textsuperscript{72} maintain separate accounting records for the transactions of the business or other activity, whether or not assets of the business or other activity are segregated from other assets held by the fiduciary.

\textsuperscript{71} The reference to a unitrust distribution is added to Section 402, in view of the new unitrust provision.

\textsuperscript{72} [NEW 11/1/17] There is still the question of whether the word “may” in Section 403(b) should be “shall.”
(c) A fiduciary that accounts separately for a business or other activity under this section:

1. (1) may determine:
   
   (A) the extent to which the net cash receipts of the business must be retained for:
   
   (i) working capital,
   
   (ii) the acquisition or replacement of fixed assets, and
   
   (iii) other reasonably foreseeable needs of the business or activity;

2. and

3. (B) the extent to which the remaining net cash receipts are accounted for as principal or income in the trust’s general accounting records;

4. (2) may make the determinations under paragraph (1) separately and differently from the fiduciary’s decisions concerning distributions of income or principal; and

5. (3) shall account for the net amount received from the sale of assets of the business or other activity, other than a sale in the ordinary course of the business or activity, as principal in the trust’s general accounting records to the extent the fiduciary determines that the net amount received is no longer required in the conduct of the business or other activity.

(d) Activities for which a fiduciary may maintain separate accounting records include:

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

2. (2) farming;

3. (3) raising and selling livestock and other animals;

4. (4) management of rental properties;

5. (5) extraction of minerals and other natural resources;

[NEW 11/1/17] Section 403(c) has been broken up.
(6) timber operations;
(7) activities to which Section 413 applies; and
(8) other operating businesses.

Comment

Separate accounting. The second sentence of subsection (c) 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.

[PART 2

RECEIPTS NOT NORMALLY ALLOCATED]

SECTION 404. PRINCIPAL RECEIPTS. A fiduciary shall allocate to principal:

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

(A) a transferor during the transferor’s lifetime;

(B) an estate;

(C) a trust with a terminating income interest; or

(D) a payor under a contract naming the fiduciary as beneficiary;

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

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

(4) proceeds of property taken by eminent domain, except that proceeds awarded for a
loss of income for a period are income if a current income beneficiary had a mandatory income
interest during the period;

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

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

SECTION 405. RENTAL PROPERTY. To the extent the fiduciary does not account
separately under Section 403 for the management of a rental property, the fiduciary 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, except as otherwise provided by law, and is
not available for distribution to a beneficiary until the fiduciary’s contractual obligations have
been satisfied with respect to that amount.

SECTION 406. RECEIPT ON AN OBLIGATION TO BE PAID IN MONEY.

(a) This section does not apply to an obligation to which Section 408, 409, 410, 411, 413,
or 414 applies.

(b) An amount received as interest on an obligation to pay money to a fiduciary, including
an amount received as consideration for prepaying principal, must be allocated to income without
any provision for amortization of premium.

(c) A fiduciary shall allocate to principal an amount received from the sale, redemption, or
other disposition of an obligation to pay money to the fiduciary more than one year after it is
acquired by the fiduciary, 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 acquired by the fiduciary, an amount received that exceeds its purchase price or its value when acquired by the fiduciary must be allocated to income.\textsuperscript{74}

SECTION 407. INSURANCE POLICIES AND SIMILAR CONTRACTS.

(a) This section does not apply to a contract to which Section 408 applies.

(b) Except as otherwise provided in subsection (c), a fiduciary shall allocate to principal the proceeds of a life insurance policy or other contract received by the fiduciary as beneficiary, including a contract that insures against loss for damage to, destruction of, or loss of title to an asset. The fiduciary 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.

(c) A fiduciary shall allocate to income proceeds of a contract that insures the fiduciary against loss of occupancy or other use by a current income beneficiary, loss of income, or, subject to Section 403, loss of profits from a business.

[PART 3

RECEIPTS NORMALLY APPORTIONED]

SECTION 408. DEFERRED COMPENSATION, ANNUITIES, AND SIMILAR PAYMENTS.\textsuperscript{75}

(a) This section does not apply to a payment to which Section 409 applies.\textsuperscript{76}

(b) In this section:

(1) “Payment” means an amount a fiduciary may receive over a fixed number of

\textsuperscript{74} In the previous draft (and in the current UPIA) the first and third occurrences of the word “acquired” in Section 406(c) were stated as “purchased or acquired.” The use of the word “purchased” begs the question “purchased by whom?” The only reasonable answer is purchased by the fiduciary, but then it means the same as “acquired” anyway.

\textsuperscript{75} Section 408 is still under review, possibly with help from Susan Porter and a group she chairs.

\textsuperscript{76} [NEW 11/1/17] This subsection (a) is moved from the end to the beginning, consistently with other Style Committee suggestions.
years or during the life of one or more individuals because of services rendered or property
transferred to the payor in exchange for future receipts. The term includes an amount drawn in
money or property from the payor’s general assets or from a separate fund created by the payor.
For purposes of subsections (f), (g), (h), and (i), the term also includes an amount drawn from
any separate fund, regardless of the reason for the withdrawal.

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

(c) To the extent a payment is characterized by the payor as interest, a dividend, or a
payment made instead of interest or a dividend, a fiduciary shall allocate the payment to income.
The fiduciary shall allocate to principal the balance of the payment and any other payment
received in the same accounting period that is not characterized as interest, a dividend, or a
payment made instead of interest or a dividend.  

(d) 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 fiduciary 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 fiduciary is entitled, the fiduciary 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 fiduciary exercises a right of withdrawal.

(e) The percentage used under subsection (d) must be 10 percent, unless the fiduciary
selects a different percentage in a record.

This change makes the two sentences parallel.
(f) Except as otherwise provided in subsection (g), subsections (h) and (i) apply, and subsections (c) and (d) 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].

(g) Subsections (f), (h), and (i) do not apply if and to the extent the series of payments would, without the application of subsection (f), 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].

(h) 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.

78 This subsection might be reviewed in light of the discussion at the ACTEC Employee Benefits Committee meeting in Seattle.
(i) 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.

SECTION 409. 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 408, natural resources subject to Section 410, timber subject to
Section 411, an activity subject to Section 413, an asset subject to Section 414, or any asset for
which the fiduciary establishes a reserve for depreciation under Section 503.

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

(c) The percentage used under subsection (b) must be 10 percent, unless the fiduciary
selects a different percentage in a record.
Comment

Prior Acts. As stated in a Comment to the 1997 Act, 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 of the 1997 Act abandoned the annuity approach under the 5% rule, but required that 10% of the receipts from a “liquidating asset” be allocated to income and the balance to principal. Section 409 generally expands this treatment to any volatile or otherwise “illiquid” asset, as defined, but allows the trustee to select a percentage other than 10% under subsection (c). This is consistent with the greater flexibility contemplated by the current act and recognizes that a fixed percentage can be arbitrary.

SECTION 410. MINERALS, WATER, AND OTHER NATURAL RESOURCES.

(a) To the extent a fiduciary accounts pursuant to this section for receipts from an interest in minerals, water, or other natural resources not accounted for as a business under Section 403, the fiduciary shall allocate the receipts 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) must be 10 percent, unless the fiduciary selects a different percentage in a record.

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

(e) If a fiduciary owns an interest in minerals, water, or other natural resources on [the effective date of this [act]], the fiduciary may allocate receipts from the interest as provided in this [act] or in the manner used by the fiduciary before [the effective date of this [act]]. If the fiduciary acquires an interest in minerals, water, or other natural resources after [the effective date of this [act]], the fiduciary shall allocate receipts from the interest as provided in this [act].

SECTION 411. TIMBER.

(a) To the extent a fiduciary accounts for receipts from the sale of timber and related products pursuant to this section, the fiduciary 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

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79 A question was raised at the March drafting committee about the clarity of “net receipts” in Section 411(a), and perhaps that will be discussed further.
the rate of growth of the timber or the net receipts are from the sale of standing timber;

(3) to income or principal or between income and principal if the net receipts are from the lease of land used for growing or cutting timber or from a contract to cut timber from land, 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 fiduciary 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, building new fences, or making repairs to structures on the property.

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

SECTION 412. MARITAL DEDUCTION PROPERTY NOT PRODUCTIVE OF INCOME.

(a) The transferor’s spouse may require the trustee of a trust for which a gift or estate tax
marital deduction was allowed to make property productive of income, convert property to
productive property within a reasonable time, or exercise the power conferred by Section 203 if
the trust assets otherwise do not provide the transferor’s spouse with sufficient income from or
use of the trust assets to qualify for the deduction. The trustee may decide which action or
combination of actions to take.\textsuperscript{80}

(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.

\textbf{SECTION 413. DERIVATIVES AND OPTIONS.\textsuperscript{81}}

(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 fiduciary does not account under Section 403 for a transaction in
derivatives, the fiduciary shall allocate to principal receipts from and disbursements made in
connection with the transaction.

(c) If a fiduciary 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

\textsuperscript{80} Section 412(a) is rewritten. Previously it stated: “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.”

\textsuperscript{81} Sections 413 and 414 are still under review, with help from Paul Lee.
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 fiduciary 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.

SECTION 414. 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 401 or 408 applies.

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

(d) The percentage used under subsection (c) must be 10 percent, unless the fiduciary
selects a different percentage in a record.

SECTION 415. OTHER FINANCIAL INSTRUMENTS AND ARRANGEMENTS.

A fiduciary shall allocate receipts from or related to financial instruments and arrangements not explicitly addressed by this [act] in a manner consistent with the rules prescribed and the principles reflected in Sections 413 and 414.

Comment

Section 415 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.

SECTION 416. INSUBSTANTIAL ALLOCATIONS NOT REQUIRED. If a fiduciary determines that an allocation between income and principal required by Section 408, 409, 410, 411, or 414 is insubstantial, the fiduciary may allocate the entire amount to principal, unless Section 203(c) applies to the allocation. This power may be exercised by a co-fiduciary in the circumstances described in Section 203(d) and may be released for the reasons and in the manner described in Section 203(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; and

(2) the asset producing the receipt to be allocated has a fair market value less than 10 percent of the total fair market value of a trust’s assets at the beginning of the accounting period.

82 The word “or” is changed to “and” here to narrowly apply the Section 416 exception to cases where both tests are satisfied.
ALLOCATION OF DISBURSEMENTS DURING ADMINISTRATION

SECTION 501. DISBURSEMENTS FROM INCOME. A fiduciary 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 fiduciary and of any person providing investment advisory, custodial, or other services to the fiduciary; 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 fiduciary that is an independent person determines that making those disbursements from income would be in the interests of the beneficiaries because principal is illiquid or otherwise;

(3) all the other ordinary expenses incurred in connection with the administration, management, or preservation of 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.

[NEW 11/1/17] The word “fiduciary” had been added to Section 501(1)(A) as a modifier of “services” to cover trust directors under the UDTA. Because the now-approved UTDA treats trust directors as fiduciaries, that addition is unnecessary and is deleted from this draft. (It was awkward anyway to envision the trust director “providing fiduciary … services to the fiduciary.”) But the word “other” is added to be safe.

[NEW 11/1/17] the reference to an “independent person” is retained in Section 501(2).

[NEW 11/1/17] The new reference to an “independent person” in Section 501(2) picks up the new definition of “independent person” in Section 102(9). See also Section 201(a)(4) and (5) and the Comment to Section 201.
Paying more than half of certain disbursements from income. Section 501(2) is added to be consistent with other parts of the Act, such as Section 201(a)(4) and (5), that favor principal when appropriate.

SECTION 502. DISBURSEMENTS FROM PRINCIPAL.

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

(1) the remaining one-half of the disbursements described in Section 501(1) after application of Section 501(2);

(2) all the fiduciary’s compensation calculated on principal as a fee for acceptance, distribution, or termination, and disbursements made to prepare for or execute a sale or other disposition of the property;\(^{86}\)

(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 501(4) of which the fiduciary 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

\(^{86}\) This reference in Section 502(a)(2) to “prepare for or execute a sale or other disposition of the property” replaces “prepare property for sale” and is intended to more clearly cover the cost of appraisals, land use appraisals, remediation, and the like, which will be noted in a Comment.
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 fiduciary 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.

SECTION 503. 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 fiduciary 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; or

(2) under this section if the fiduciary is accounting under Section 403 for the
business or activity in which the asset is used.\textsuperscript{87}

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

\textsuperscript{87} The former paragraph (2) of Section 503(b) “(during the administration of a decedent’s estate”) has been deleted
as redundant in view of the current broadening of the explicit wording throughout the Act to “fiduciaries,” including
personal representatives.
SECTION 504. TRANSFERS FROM INCOME TO REIMBURSE PRINCIPAL. 88

(a) If a fiduciary makes or expects to make a principal disbursement described in this section, the fiduciary 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 fiduciary 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 502(a)(7).

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

88 The drafting committee might discuss whether a reciprocal provision for reimbursing income from principal is needed.
SECTION 505. INCOME TAXES.

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

(b) A tax required to be paid by a fiduciary 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 that receipts from the entity are allocated only to income;

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

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

   (4) from principal to the extent that 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 that the trust’s taxes are reduced because the trust receives a deduction for payments made to a beneficiary.89

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

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89 [NEW 11/1/17] In the most recent version, subsection (c) stated “A tax required to be paid by a fiduciary on the trust’s share of an entity’s taxable income must be paid from principal to the extent the tax exceeds the total receipts from the entity” (basically only subsection (c)(4) above) and there was no subsection (d). The version above is the original 2008 version. Steve Gorin pointed out that the deletion of subsections (c)(1), (c)(2), (c)(3), and (d) seems to have been inadvertent.
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.

SECTION 506. ADJUSTMENTS BETWEEN INCOME AND PRINCIPAL

BECAUSE OF TAXES.  

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

(1) elections and decisions, other than those described in subsection (b), the

(2) an income tax or any other tax that is imposed upon the fiduciary or a

beneficiary as a result of a transaction involving or a distribution from the 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 fiduciary 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


[NEW 11/1/17] There has been considerable discussion about Section 506, including whether the third word of
subsection (a) – “may” – should be “shall,” making the adjustments mandatory, not discretionary, especially because
subsection (c) uses the word “shall.” (In a previous draft, subsection (c) was copied into Section 506 from Section
505, which generally uses the word “must.”) Concerns have been expressed about the Heller case. The point has
also been made that there should be a comment about the scope of Section 506. For purposes of this draft, although
Comments have generally not been updated, the Comment on Section 506 in the 1997 Act has been restored. We
have made no changes to the 1997 version of Section 506 except generic changes in wording (deleting “estate,”
changing “remainder” to “successor,” placing “income” before “principal, etc.) and the addition of subsection (c).
The drafting committee might also consider why subsection (c) is now used in both Sections 505 and 506.

This enumeration might be further clarified.
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.

(c) After applying Section 505, the fiduciary 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.92

Comment to 1997 Act

Discretionary adjustments. Section 506(a) permits the fiduciary to make adjustments
between income and principal because of tax law provisions. It would permit discretionary
adjustments in situations like these: (1) A fiduciary elects to deduct administration expenses that
are paid from principal on an income tax return instead of on the estate tax return; (2) a
distribution of 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 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

Section 506(a)(3) applies to a qualified Subchapter S trust (QSST) whose income
beneficiary is required to include a pro rata share of the S corporation’s taxable income in his
return. If the QSST does not receive a cash distribution from the corporation that is large enough
to cover the income beneficiary’s tax liability, the trustee may distribute additional cash from
principal to the income beneficiary. In this case the retention of cash by the corporation benefits

92 This Section 506(c) has been moved here from Section 505.
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 fiduciary elects to deduct administration
expenses on an income tax return instead of the estate tax return. Unlike the New York
 provision, subsection (b) limits a mandatory reimbursement to cases in which a marital deduction
or a charitable contributions deduction is reduced by the payment of additional estate taxes
because of the fiduciary’s income tax election. It is intended to preserve the result reached in
Estate of Britenstool v. Commissioner, 46 T.C. 711 (1966), in which the Tax Court held that a
reimbursement required by the predecessor of EPTL § 11-1.2(A) resulted in the estate receiving
the same charitable contributions deduction it would have received if the administration expenses
had been deducted for estate tax purposes instead of for income tax purposes. Because a
fiduciary will elect to deduct administration expenses for income tax purposes only when the
income tax reduction exceeds the estate tax reduction, the effect of this adjustment is that the
principal is placed in the same position it would have occupied if the fiduciary had deducted the
expenses for estate tax purposes, but the income beneficiaries receive an additional benefit. For
example, if the income tax benefit from the deduction is $30,000 and the estate tax benefit would
have been $20,000, principal will be reimbursed $20,000 and the 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.
DEATH OF DECEDENT OR TERMINATION OF INCOME INTEREST\textsuperscript{93}

SECTION 601. DETERMINATION AND DISTRIBUTION OF NET INCOME.

(a) The rules in this section apply after a decedent dies in the case of an estate or after an income interest in a trust ends.

(b) A fiduciary of an estate or a terminating income interest shall determine the amount of net income and net principal receipts received from property specifically given to a beneficiary under the rules in [Articles] 4, 5, and 7\textsuperscript{94} and the rules in subsection (f). The fiduciary shall distribute the net income and net principal receipts to the beneficiary who is to receive the specific property.

(c) A fiduciary shall determine the income and net income of an estate or a terminating income interest, other than the amount of net income determined under subsection (b), under the rules in [Articles] 4, 5, and 7 and by:

(1) including in net income all income from property used or sold to discharge liabilities;

(2) 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 estate and inheritance taxes and other taxes imposed by reason of the death of a

\textsuperscript{93} This title was formerly “DECEDENT’S ESTATE OR TERMINATING INCOME INTEREST.” The terms were flagrantly unparallel: the “decedent’s estate” is something that is beginning and the “terminating income interest” is something that is ending. Moreover, the word “decedent’s” in reference to an “estate” has been uniformly deleted from this draft as redundant. See the footnote to Section 102(17) on the use of “decedent’s estate.”

\textsuperscript{94} Here and in subsection (c) there had been the clause “which apply to trustees.” That is deleted because the general term throughout the Act is now “fiduciary.”
decedent, but the fiduciary may pay those expenses from income of property passing to a trust for which the fiduciary claims a federal 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

(3) paying from principal all other disbursements made or incurred in connection with the settlement of an 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, estate and inheritance taxes, and other taxes imposed by reason of the death of a decedent 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.

(d) 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 subsection (c) 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.

(e) A fiduciary shall distribute the net income remaining after distributions required by subsection (d) in the manner described in Section 602 to all other beneficiaries, including a

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95 [NEW 11/1/17] In the previous draft the politicized term “death taxes” was changed in Section 601(c)(2) and (3) to “estate and inheritance taxes.” To be sure that no “death tax” is omitted, the words “and other taxes imposed by reason of the death of a decedent” are now added to those provisions.
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.

(f) A fiduciary may not reduce principal or income receipts from property described in subsection (b) because of a payment described in Section 501 or 502 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.

SECTION 602. DISTRIBUTION TO RESIDUARY AND REMAINDER BENEFICIARIES.

(a) Except to the extent [Article] 3 applies in the case of a beneficiary that is a trust, each beneficiary described in Section 601(e) 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 fiduciary makes more than one distribution of assets to beneficiaries to whom this section applies, each beneficiary, including one who does not receive part of the distribution, is entitled, as of each distribution date, to the net income the fiduciary has received.

96 [NEW 11/1/17] Bill LaPiana asked: “In light of § 302(a), if the residuary clause is ½ outright to X, ½ in trust, could the ‘net income’ of the first ½ be the income as traditionally determined and the ‘net income’ of the other half a unitrust amount?” Because the answer appears to be yes, the first clause has been added to Section 602(a).
after the date of the decedent’s death or an income interest’s terminating event or previous distribution date.97

(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 be98 calculated without regard to:

(A) property specifically given to a beneficiary under the decedent’s will or the terms of the trust;99 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 fiduciary calculates the value of the assets if that date is reasonably near the date on which the assets are actually distributed.

(c) If a fiduciary does not distribute all the collected but undistributed net income to each

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97 Instead of changing “current distribution date” to “given date” at the end of Section 602(a) as John Langbein suggested, this draft simply deletes “but has not distributed as of the current distribution date” as surplus. The word “earlier” (now the third-from-last word of the subsection) is changed to the more precise word “previous.”

98 In March, the drafting committee suggested changing “must be” to “is” in Section 602(b)(2). The term “must be” is used 39 times in the current draft, and almost all of those references could conveniently be changed to “is.” Likewise with phrases such as “shall be,” “shall be allocated,” and “the fiduciary shall allocate.” Those changes have not been made yet, either here or elsewhere. Should they be?
person as of a distribution date, the fiduciary shall maintain appropriate records showing the
interest of each beneficiary in the net income.

(d) A fiduciary may apply the rules in this section, to the extent the fiduciary considers it
appropriate, to net gain or loss realized after the date of the decedent’s death or an income
interest’s 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.  

[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) becomes subject to a successive income interest in the case of a successor

beneficiary.

(b) An asset becomes subject to a trust:

99 The words “under the decedent’s will or the terms of the trust” are added in Section 602(b)(2)(A). Section
102(17), defining “terms of the trust,” states: “In the case of an estate, the term includes a will.” Here, however, a
will is so clearly the point of the provision that it seems awkward to merely insert a reference to “terms of the trust.”

100 Is it clear from the text of the Act that a specific bequest does not share in the income earned by other assets?
(1) on the date the asset is transferred to the trust in the case of an asset that is transferred to a trust during the transferor’s life;

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

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

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

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

SECTION 702. APPORTIONMENT OF RECEIPTS AND DISBURSEMENTS

WHEN DECEDENT DIES OR INCOME INTEREST BEGINS.

(a) A fiduciary 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 fiduciary shall allocate a periodic 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. A receipt or disbursement is periodic if it must be paid at regular intervals under an obligation to
make payments or if a payor customarily makes payments at regular intervals. An income receipt or disbursement must be treated as accruing from day to day if it 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 payor 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 401 applies are deemed to be due on the date fixed by the entity for determining who is entitled to receive the distribution or, if no date is fixed, on the declaration date for the distribution.

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.

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101 This sentence is moved here in subsection (b) of Section 702 from the end of subsection (c) at John Langbein’s suggestion, to demystify the use of the term “periodic” earlier. In addition, “periodic” now modifies the “receipt or disbursement,” not the “due date,” making it consistent with Section 504(b)(4), the only other place “periodic” is used. Conforming changes are made in the previous sentence, where “periodic” is moved up before “income receipt or disbursement,” and the following sentence, where “its due date” is changed to simply “it.” Finally, “an entity” is changed to “a payor” in this sentence because there seems to be no reason to distinguish entities for this purpose, and subsection (c) uses “payor.”

102 Here in Section 702(b) is an example of where the phrase “must be treated as accruing” could be changed to simply “accrues.” See Section 602(b)(2) and the corresponding footnote.
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 fiduciary 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 withdraw more than five percent of the trust immediately before the income interest ends. If the beneficiary has an unqualified power to withdraw 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 withdrawn must be added to principal.

(c) When a fiduciary’s obligation to pay a fixed annuity or a fixed fraction of the value of the trust’s assets ends, the fiduciary 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. In a Comment to Section 303 of the 1997 Act, the 1997 Drafting Committee stated that this is probably not what

103 Here in Section 703(b) the word “revoke” is changed to “withdraw,” as the drafting committee suggested. Similar changes are made in the next sentence. The word “revoke” or its variations does not appear anywhere else in the Act.

104 The drafting committee questioned what the word “fixed” adds before “annuity” in Section 703(c). It is used various ways 10 times in the Act. But it seems to do no harm, and it is possible that it has come to be relied on.
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. It decided not to eliminate this provision, however, 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 who incurs 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 an 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.”

[ARTICLE] 8

MISCELLANEOUS PROVISIONS

SECTION 801. 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 802. APPLICATION OF [ACT] TO EXISTING TRUSTS AND ESTATES. This [act] applies to a trust or 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 803. TRANSITIONAL MATTERS. Section 408, as amended by this [amendment], applies to a trust described in Section 408(e) on and after the following date:

(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; or

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

**Alternative B**

**SECTION 803. TRANSITIONAL MATTERS.** Section 408 applies to a trust
described in Section 408(e) on and after the following date:

(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; or

(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 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 408 and 505, as amended by these amendments, instead of the text of the previous
version of those Sections.

**SECTION 804. 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 your state lacks a general severability statute or a
decision by your state’s highest court stating a general rule of severability.
SECTION 805. REPEALS; CONFORMING AMENDMENTS.

(a) . . . .

(b) . . . .

(c) . . . .

SECTION 806. EFFECTIVE DATE. This act takes effect . . . .