

D R A F T
FOR DISCUSSION ONLY

UNIFORM PRINCIPAL AND INCOME ACT (199__)

NATIONAL CONFERENCE OF COMMISSIONERS
ON UNIFORM STATE LAWS

MEETING IN ITS ONE-HUNDRED-AND-FOURTH YEAR
KANSAS CITY, MISSOURI

JULY 28 - AUGUST 4, 1995

UNIFORM PRINCIPAL AND INCOME ACT (199__)

WITH PREFATORY NOTE AND COMMENTS

COPYRIGHT 1995
By
NATIONAL CONFERENCE OF COMMISSIONERS
ON UNIFORM STATE LAWS

The ideas and conclusions herein set forth, including drafts of proposed legislation, have not been passed upon by the National Conference of Commissioners on Uniform State Laws. They do not necessarily reflect the views of the Committee, Reporters or Commissioners. Proposed statutory language, if any, may not be used to ascertain legislative meaning of any promulgated final law.

DRAFTING COMMITTEE TO REVISE UNIFORM PRINCIPAL AND INCOME ACT

MATTHEW S. RAE, JR., 37th Floor, 777 South Figueroa Street, Los Angeles, CA 90017, Chair
FRANK W. DAYKIN, 4745 Giles Way, Carson City, NV 89704
E. EDWIN ECK, II, University of Montana, School of Law, P.O. Box 8911, Missoula, MT 59807
JOANNE B. HUELSMAN, Room 417 South, State Capitol, P.O. Box 7882, Madison, WI 53707
L. S. JERRY KURTZ, JR., 810 N Street, Anchorage, AK 99501
EDWARD F. LOWRY JR., 15th Floor, 2901 North Central Avenue, Phoenix, AZ 85012
ROBERT A. STEIN, American Bar Association, 750 North Lake Shore Drive, Chicago,
IL 60611
HARRY M. WALSH, Office of Revisor of Statutes, 700 State Office Building, St. Paul, MN 55155
JOEL C. DOBRIS, University of California at Davis, School of Law, King Hall, Davis, CA 95616,
Co-Reporter
E. JAMES GAMBLE, Suite 1300, 525 North Woodward Avenue, Bloomfield Hills, MI 48304,
Co-Reporter

EX OFFICIO

RICHARD C. HITE, 200 West Douglas Avenue, Suite 630, Wichita, KS 67202, President
JOHN H. LANGBEIN, Yale Law School, P.O. Box 208215, New Haven, CT 06520,
Chair, Division D

EXECUTIVE DIRECTOR

FRED H. MILLER, University of Oklahoma, College of Law, 300 Timberdell Road, Norman,
OK 73019, Executive Director
WILLIAM J. PIERCE, 1505 Roxbury Road, Ann Arbor, MI 48104, Executive Director Emeritus

Copies of this Act may be obtained from:

NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS
676 North St. Clair Street, Suite 1700
Chicago, Illinois 60611
312/915-0195

UNIFORM PRINCIPAL AND INCOME ACT (199__)

TABLE OF CONTENTS

ARTICLE 1. DEFINITIONS AND GENERAL PRINCIPLES

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

ARTICLE 2. DECEDENTS' ESTATES AND TERMINATING TRUSTS

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

ARTICLE 3. APPORTIONMENT AT THE BEGINNING AND END OF AN INCOME INTEREST

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

ARTICLE 4. ALLOCATION OF RECEIPTS DURING ADMINISTRATION OF A TRUST

PART 1. DISTRIBUTIONS FROM ENTITIES

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

PART 2. RECEIPTS NOT NORMALLY APPORTIONED

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

PART 3. RECEIPTS NORMALLY APPORTIONED

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

ARTICLE 5. ALLOCATION OF DISBURSEMENTS DURING ADMINISTRATION OF A TRUST

§ 501	Disbursements From Income
§ 502	Disbursements From Principal
§ 503	Transfer From Income to Principal for Depreciation
§ 504	Transfer From Income for Principal Disbursements

§ 505 Income Taxes
§ 506 Equitable Adjustments Between Principal and Income Because of Taxes

ARTICLE 6. EQUITABLE ADJUSTMENTS

§ 601 Trustee's Power to Reallocate

ARTICLE 7. MISCELLANEOUS PROVISIONS

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

1 **UNIFORM PRINCIPAL AND INCOME ACT (199__)**

2 **PREFATORY NOTE**

3 This revision of the original and revised Acts has two main purposes.

4 The first is a general revision of the existing Acts in order to modernize
5 them. The revision deals with the regular allocation of income and expense
6 amounts in a variety of ways which are different from the 1931 and the 1962
7 Acts.

8 The second is to provide a means for dealing with the tension between
9 (a) traditional notions of what return on investments is income, and what return is
10 principal, and (b) the goal that all property of whatsoever kind held by a trustee
11 be invested in a modern fashion as a portfolio that generates a total return.

12 **Revision of the 1931 and 1962 Acts**

13 The prior Acts, and this revision, deal with four areas of trust
14 administration:

15 (1) How is income earned during the probate of an estate to be
16 distributed to those who receive, outright or in trust, specific property, pecuniary
17 amounts and the residue?

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

21 (3) When a trust ends, who gets the income that has been received but
22 not distributed; or that is due but not yet collected; or that has accrued but is not
23 yet due?

24 (4) After a trust begins and before it ends, how should its receipts and
25 disbursements be allocated to or between principal and income?

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

29 **New rules.** Some of the more significant new rules include:

30 (1) Limitations on the fiduciary's liability for acts and decisions made
31 after a proceeding described in Section 103.

32 (2) The application of the probate administration rules to terminating
33 trusts, including revocable living trusts after the grantor's death.

1 (3) The allocation between principal and income of net income from
2 derivatives, arbitrage and hedge activities.

3 (4) Disbursements made because of environmental laws.

4 (5) The income tax burden resulting from the ownership of S
5 corporation stock and interests in partnerships.

6 (6) The allocation of net income from partnership interests acquired by
7 the trustee (the old Acts deal only with partnership interests acquired from a
8 decedent).

9 (7) The power to make equitable adjustments between principal and
10 income to compensate one or the other because of tax elections or peculiarities in
11 the way the fiduciary income tax rules apply.

12 (8) A de minimis rule that permits the trustee to ignore relatively small
13 adjustments that would otherwise be required by the rigid application of the
14 apportionment rules.

15 (9) A provision that applies to net income from harvesting and selling
16 timber.

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

20 (1) Charging depreciation against income is no longer mandatory, but
21 may or may not be made in the discretion of the trustee.

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

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

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

30 (5) An "unincorporated entity" concept has been introduced to deal with
31 businesses operated by a trustee and investment activities in rental real estate,
32 natural resources, derivatives, arbitrage and hedge activities.

33 (6) The percentage used to allocate net receipts from oil and gas has
34 been changed -- 80% of those receipts are allocated to principal and the balance
35 to income.

36 (7) The 1962 Act rule for "property subject to depletion" (patents,
37 copyrights, royalties, deferred compensation and the like), calling for 5% of the
38 asset's inventory value to be allocated to income and the balance to principal, has

1 been replaced by rules allocating 80% to 90% of the net receipts to principal and
2 the balance to income.

3 (8) The unproductive property rules have been changed extensively.

4 **Coordination with the Uniform Prudent Investor Act**

5 The law of trust investment has been modernized. See Uniform Prudent
6 Investor Act (1994); Restatement (Third) of Trusts: Prudent Investor Rule
7 (1992). Now it is time to update the principal and income allocation rules so the
8 two bodies of doctrine can work well together. This revision deals with the
9 tension between modern investment theory and traditional income allocation
10 conservatively. The starting point is to use the traditional system. If prudent
11 investing of all the assets in a trust viewed as a portfolio and traditional allocation
12 effectuate the intent of the settlor, then nothing need be done. The Act, however,
13 helps the trustee who has made a prudent, modern, portfolio-based investment
14 decision that has the initial effect of skewing return from all the assets under
15 management, viewed as a portfolio, as between income and principal
16 beneficiaries. The Act gives that trustee a power to reallocate the portfolio return
17 suitably. To leave trustee-investors constrained by the traditional system would
18 inhibit the trustee's ability to fully implement the modern portfolio theory.

19 As to modern investing see, e.g., the Preface to, terms of and Comments
20 to the Uniform Prudent Investor Act (1994); the discussion and reporter's note by
21 Edward C. Halbach, Jr. in Restatement (Third) of Trusts: Prudent Investor Rule
22 (1992); Bevis Longstreth, Modern Investment Management and the Prudent Man
23 Rule (1986); John H. Langbein & Richard A. Posner, The Revolution in Trust
24 Investment Law, 62 A.B.A.J. 887 (1976); and Jeffrey N. Gordon, The Puzzling
25 Persistence of the Constrained Prudent Man Rule, 62 N.Y.U.L. Rev. 52 (1987).
26 See also R.A. Brearly, An Introduction to Risk and Return from Common Stocks
27 (2d ed. 1983); Jonathan R. Macey, An Introduction to Modern Financial Theory
28 (1991). As to the need for principal and income reform see, e.g., Joel C.
29 Dobris, Real Return, Modern Portfolio Theory and College, University and
30 Foundation Decisions on Annual Spending From Endowments: A Visit to the
31 World of Spending Rules 28 Real Prop., Prob., & Tr.J. 49 (1993); Joel C.
32 Dobris, The Probate World at the End of the Century: Is a New Principal and
33 Income Act in Your Future? 28 Real Prop., Prob., & Tr.J. 393 (1993) and
34 Kenneth L. Hirsch, Inflation and the Law of Trusts, 18 Real Prop., Prob., &
35 Tr.J. 601 (1983). See also, Jerold I. Horn, The Prudent Investor Rule -- Impact
36 on Drafting and Administration of Trusts, 20 ACTEC Notes 26 (Summer 1994).

1 **UNIFORM PRINCIPAL AND INCOME ACT (199__)**

2 **[ARTICLE] 1**
3 **DEFINITIONS AND FIDUCIARY DUTIES**

4 **SECTION 101. DEFINITIONS.**

5 (a) In this [Act]:

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

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

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

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

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

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

3 (4) "Fiduciary" means a personal representative or a trustee.

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

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

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

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

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

1 (11) "Net income" means the total receipts allocated to income
2 during an accounting period minus the disbursements and other items charged to
3 income during that period.

4 (12) "Personal representative" includes an executor, administrator,
5 successor personal representative, special administrator, and a person who
6 performs substantially the same function under the law governing their status.

7 (13) "Principal" means property held in trust for distribution to a
8 remainder beneficiary when the trust terminates.

9 (14) "Remainder beneficiary" means a person, including another
10 trust, who is entitled to receive principal and the undistributed income that is
11 added to principal pursuant to the governing instrument or under Section 303
12 when an income interest ends.

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

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

17	"Carrying charge"	Section 426(h)
18	"Computation period"	Section 426(f)
19	"Controlled entity"	Section 401(2)
20	"Deferred compensation"	Section 422(a)
21	"Delayed income"	Section 426(e)
22	"Due date"	Section 304
23	"Entity"	Section 401(1)
24	"Inventory value"	Section 426(d)
25	"Liquidating Asset"	Section 423(a)
26	"Net proceeds"	Section 426(g)

1	"Partial liquidation"	Section 402(c)
2	"Successive income interest"	Section 201(a)
3	"Terminating trust"	Section 201(b)
4	"Undistributed income"	Section 303(b)
5	"Unproductive property"	Section 426(a)

6 **Comment**

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

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

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

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

23 (a) A fiduciary shall administer a trust or estate impartially, considering
24 all of the interests of all of its beneficiaries. A trust or estate is administered
25 impartially with respect to a matter provided for in this [Act] if the fiduciary
26 makes a determination:

27 (1) in accordance with the provisions of the governing instrument,
28 notwithstanding a contrary provision of this [Act];

29 (2) by the good faith exercise of a discretionary power given the
30 fiduciary by the governing instrument;

31 (3) in the absence of a contrary provision or a grant of discretion in
32 the governing instrument, in accordance with the provisions of this [Act]; or

1 (4) if paragraphs (1), (2) and (3) do not apply, in accordance with
2 what is fair and reasonable to all of the beneficiaries.

3 (b) If a fiduciary is in doubt about what is fair and reasonable in
4 applying the provisions of the governing instrument or [Articles] 1 through 5 of
5 this [Act] to a particular situation, the fiduciary shall resolve the doubt by adding
6 the receipt or charging the disbursement to principal.

7 (c) If the governing instrument gives a fiduciary discretion to determine
8 a matter for which there is a provision in this [Act], partiality may not be inferred
9 if the fiduciary makes a determination contrary to the provision.

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

18 **Comment**

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

24 This draft deletes the language at the end of 1962 Act Section 2(a)(3) --
25 "and in view of the manner in which men of ordinary prudence, discretion and
26 judgment would act in the management of their affairs" -- because persons of
27 ordinary prudence, discretion and judgment, acting in the management of their
28 own affairs don't normally think in terms of the interests of successive
29 beneficiaries. If there is an analogy to an individual's decision-making process, it
30 is probably the individual's decision to spend or to save, but this is not a useful
31 guideline for trust administration. The annotations to the 1962 Act Section 2 do
32 not show a case in which a court has relied on that Act's "prudent man" rule.

1 The allocation of doubtful items to principal, as provided in subsection
2 (b), will initially favor the income beneficiary if the doubtful item is a
3 disbursement, but thereafter it will reduce the income produced by principal. If
4 the doubtful item is a receipt, it will initially favor the remainder beneficiary, but
5 thereafter will favor the income beneficiary by increasing the annual income.

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

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

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

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

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

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

1 beneficiaries of the decision not to implement it and the reasons for that decision.
2 A beneficiary may petition the court to have the action or decision implemented,
3 and has the burden of proving that it should be implemented.

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

9 (d) [Procedural provisions]

10 (i) Notice to whom. Virtual representation.

11 (ii) Time within which proceeding must be brought.

12 Comment

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

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

1 [ARTICLE] 2
2 DECEDENTS' ESTATES AND TERMINATING TRUSTS

3 **SECTION 201. INTRODUCTORY PROVISIONS.**

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

9 (b) "Terminating trust" means a trust in which a partial or complete
10 termination of an income interest occurs and assets subject to that interest are
11 distributed free of trust or become subject to one or more successive income
12 interests, or both.

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

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

20 (1) A fiduciary of an estate or terminating trust shall determine the net
21 income from property specifically given to a beneficiary by subtracting from the
22 property's income all disbursements attributable to the property or its income that
23 the fiduciary makes before the property is distributed or will be obligated to make
24 after it is distributed. The property's income includes income accrued or due

1 before, on, or after the date of the decedent's death or an income interest's
2 terminating event. If the fiduciary makes disbursements because of
3 environmental laws that apply to the property, and if the total disbursements not
4 covered by insurance exceeds the property's income, the excess must be borne by
5 the property. Excess disbursements that do not relate to environmental
6 obligations must be paid from principal other than the property. In determining
7 which disbursements cause the total disbursements to exceed the income,
8 environmental disbursements are to be subtracted last from income without
9 regard to the order in which disbursements are made.

10 (2) The fiduciary shall determine the remaining net income of a
11 decedent's estate or terminating trust under the rules in [Articles] 3 through 6 that
12 apply to trustees and by:

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

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

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

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

1 (1) to a beneficiary who is to receive specific property, outright or in
2 trust, the net income from the property as determined under Section 202(1);
3 (2) to a beneficiary who is to receive a pecuniary amount outright, the
4 amount, if any, provided by applicable law or the governing instrument; and
5 (3) to all other beneficiaries, the balance of the net income. Each
6 beneficiary shall receive a percentage of the net income equal to the beneficiary's
7 percentage interest in the estate or trust as of the distribution date. This
8 paragraph applies to a trust that receives a pecuniary amount even though a
9 beneficiary holds a presently exercisable general power of appointment over the
10 trust, including an unqualified power to withdraw trust assets.

11 Comment

12 This section carries forward the distinction in Section 5(2) of the 1962
13 Act between outright pecuniary bequests and those made in trust. Paragraph 2
14 now provides for the beneficiary of an outright pecuniary amount to receive the
15 interest or other amount provided by applicable law, but it does not provide for
16 the situation in which there is no applicable law or governing instrument
17 provision. The Committee considered adding a provision at the end of paragraph
18 2 that said, "but if there is no applicable law or governing instrument provision, [
19] percent per year beginning [twelve] months after a decedent dies or the event
20 occurs that causes the pecuniary amount to become payable from a trust." The
21 consensus of the Drafting Committee was that, since many States now have
22 applicable provisions, at least as to pecuniary bequests in wills, this question
23 should be resolved on a state by state basis to avoid the possibility of overlapping
24 or inconsistent provisions. The problem that should be addressed in each State is
25 that applicable law provisions for paying interest on pecuniary gifts usually apply
26 only to pecuniary bequests under wills and not to pecuniary gifts payable from
27 trusts.

28 The various state authorities that provide for the amount that a
29 beneficiary of an outright pecuniary amount is entitled to receive are collected in
30 Covey, Marital Deduction and Credit Shelter Dispositions and the Use of
31 Formula Provisions App. B (Supp. 1993).

32 **SECTION 204. PARTIAL DISTRIBUTIONS.**

33 (a) If a fiduciary makes more than one distribution of assets to
34 beneficiaries who are to receive net income pursuant to Section 203(3), all of
35 those beneficiaries, including those who do not receive part of the distribution,

1 are entitled, as of each distribution date, to the net income the fiduciary has
2 received after the date of death or terminating event or earlier distribution date
3 but has not distributed as of the current distribution date. In determining a
4 beneficiary's share of net income:

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

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

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

19 Comment

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

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

25 The provisions in Section 204 are intended to make it clear that the
26 "gross-net share" method (using the terminology Covey used in an article at 2
27 Real Prop., Prob. and Tr. L. J. 1, 8-9 (1967)) is to be used in determining the
28 amount of income due to residuary beneficiaries and recipients of pecuniary gifts
29 in trust; that no redeterminations are to be made of their respective shares in net
30 income just because assets are sold and principal obligations are paid between the
31 times when distributions are made to beneficiaries; and that no principal or

1 income receipts or disbursements are to be accrued or anticipated in computing
2 net income when a distribution is made. In other words, a strict cash receipts
3 and disbursements method of accounting is to be applied.

1
2
3

4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19

20
21
22
23
24

[ARTICLE] 3
APPORTIONMENT AT BEGINNING
AND END OF INCOME INTEREST

SECTION 301. WHEN RIGHT TO INCOME BEGINS.

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

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

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

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

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

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

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

(a) A receipt that would normally be income under [Article] 4 must be allocated to principal if it is due or accrues before a decedent dies or before the

principal asset that produces the receipt becomes subject to a trust unless it is a receipt from property that is governed by Section 202(1).

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

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

Comment

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

Having two different rules is confusing. In order to simplify administration, Section 302 applies the same apportionment rule to inter vivos trusts (revocable and irrevocable), testamentary trusts and assets that become subject to an inter vivos trust through a pour-over bequest in a will. There is no apparent policy reason for the 1962 Act distinction, and Professor Bogert does not explain why different rules should apply. Income accrued before a person dies or a trust begins will be income under this Act only in the case of property specifically given to a devisee or remainder beneficiary (see subsection 202(1)).

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

(a) When a mandatory income interest ends, a mandatory income beneficiary who survives that date or the estate of a deceased mandatory income

1 beneficiary whose death causes the interest to end is entitled to the beneficiary's
2 share of the undistributed income that is not disposed of by the governing
3 instrument, but undistributed income from assets or the proceeds of assets that a
4 mandatory income beneficiary transferred to the trust must be added to principal.

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

10 Comment

11 The definition of undistributed income in subsection (b) is different from
12 the provision in Section 4(d) of the 1962 Act. Accrued items are excluded from
13 the definition of undistributed income. The requirement that undistributed
14 income include only net income received is intended to exclude "accruals" of
15 discount on deep discount and zero coupon bonds. Accrued charges and accrued
16 income would both be allocated to principal under Section 302.

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

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

28 **SECTION 304. WHEN INCOME OR OBLIGATIONS ARE DUE.** A due
29 date for an item of income or an obligation is the date on which the payor is
30 obligated to make a payment that is required to be paid on or before a stated date.
31 If there is no stated date, there is no due date for the purposes of this [Act].
32 Corporate distributions to stockholders are deemed to be due on the date fixed by

- 1 the corporation for determination of stockholders of record entitled to distribution
- 2 or, if no date is fixed, on the declaration date for the corporate distribution.

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26
27

[ARTICLE] 4
ALLOCATION OF RECEIPTS DURING
ADMINISTRATION OF TRUST

[PART] 1
DISTRIBUTIONS FROM ENTITIES

SECTION 401. DEFINITIONS.

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

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

Comment

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

SECTION 402. CHARACTER OF DISTRIBUTIONS.

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

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

- 1 (1) a distribution of its own shares or other units of equity,
2 securities or obligations, including a distribution in the form of a stock split or
3 stock dividend or a comparable distribution from a noncorporate entity;
- 4 (2) a distribution of shares, other units of equity, securities or
5 obligations of an entity other than the distributing entity;
- 6 (3) a distribution of rights to subscribe to shares, other units of
7 equity, securities, or obligations of the distributing entity or another entity and
8 the proceeds of those rights;
- 9 (4) a distribution from an entity that is a regulated investment
10 company or a real estate investment trust if it is a capital gain dividend for
11 federal income tax purposes whether in the form of cash or additional stock; and
- 12 (5) except to the extent that an entity indicates that some part of a
13 corporate distribution is a settlement of preferred or guaranteed dividends accrued
14 since the trustee became a stockholder, a distribution that is pursuant to:
- 15 (i) a call of shares or other units of equity ownership;
- 16 (ii) a merger, consolidation, reorganization, or other plan by
17 which assets of the entity are acquired by another entity; or
- 18 (iii) a total or partial liquidation of the entity.
- 19 (c) "Partial liquidation" means:
- 20 (1) a distribution that the entity, at or near the time of distribution,
21 indicates is a distribution in partial liquidation;
- 22 (2) a distribution or series of related distributions by an entity in an
23 amount greater than [20] percent of the entity's gross assets, as shown by the
24 entity's annual financial statements for the year-end immediately preceding the
25 initial distribution.

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

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

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

14 Comment

15 Under the Internal Revenue Code and the Income Tax Regulations, a
16 "capital gain dividend" from a mutual fund or an REIT is the excess of the fund's
17 net long-term capital gain over its net short term capital loss. As a result, a
18 fund's net short-term capital gain is not includable in a fund's capital gain
19 dividend. Moreover, information on a fund's net short-term capital gain is
20 frequently difficult or impossible to obtain. The Committee has continued the
21 treatment of these capital gain dividends as principal, but no inference should be
22 drawn that distributions from other entities that have their origin in an entity-level
23 transaction that is treated as a long-term capital gain for income tax purposes is
24 principal for the purposes of this Act. (See subsection (e).)

25 **SECTION 403. OTHER TRUSTS AND ESTATES.** Income includes net
26 income received from an estate or a terminating trust pursuant to Section 203 and
27 income distributed by another trust in which the trust has an income interest.
28 Principal includes a distribution in liquidation of an interest in a common trust
29 fund or any other trust to which a trustee transfers principal assets in exchange

1 for a beneficial interest, and it includes a distribution from principal of another
2 trust in which a trustee has a beneficial interest because of a donative transfer.

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

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

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

15 (c) Net cash receipts from a sale of business assets not in the ordinary
16 course of business and the liquidation or contraction of the business, including
17 receipts from the collection of accounts receivable, must be transferred to trust
18 principal to the extent the trustee determines they are no longer required in the
19 conduct of the business.

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

25 Comment

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

If a fiduciary liquidates a sole proprietorship during probate or during a trust's winding-up period, Section 202(2)(ii) requires the proceeds to be added to principal, although Section 404(c) may make that provision unnecessary.

[PART] 2

RECEIPTS NOT NORMALLY APPORTIONED

SECTION 410. PRINCIPAL RECEIPTS. Principal includes:

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

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

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

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

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

Comment

Even though the award in an eminent domain proceeding may include an amount for the loss of future rent on a lease, if that amount is not separately

1 stated the entire award is principal. The rule is the same in the 1931 and 1962
2 Acts.

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

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

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

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

21 (1) The increment in value for each accounting period must be
22 determined from a fixed schedule of appreciation if one is established for that
23 obligation. If no fixed schedule is established, the increment must be the amount
24 of original issue discount that the trustee is required to report for federal income
25 tax purposes for that accounting period.

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

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

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

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

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

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

Comment

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

SECTION 413. INSURANCE POLICIES AND OTHER CONTRACTS.

1 (a) Insurance proceeds are principal if they are from a life insurance
2 policy whose beneficiary is the trust or its trustee or a policy that insures the trust
3 or its trustee against loss for the damage or destruction of a principal asset.

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

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

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

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

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

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

22 **Comment**

23 This section applies to occasional option transactions and not to options
24 granted or acquired in connection with arbitrage or hedging activities or dealings
25 in derivative financial instruments. It applies to an option to purchase real estate
26 owned by the trustee in an isolated real estate transaction and to a put option
27 purchased by a trustee to guard against a drop in value of a large block of
28 marketable stock that must be liquidated to pay estate taxes. A continuing and

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

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

8 [PART] 3
9 RECEIPTS NORMALLY APPORTIONED

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

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

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

22 Comment

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

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

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

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

6 **SECTION 422. DEFERRED COMPENSATION.**

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

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

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

22 (d) In all other cases the trustee shall allocate [20] percent of the
23 receipts to income if the trustee expects the full amount to be paid over a fixed
24 period of more than 5 years after the asset becomes subject to the trust or
25 successive income interest, or over an indefinite period, such as a life

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

Comment

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

SECTION 423. LIQUIDATING ASSETS.

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

(b) The trustee shall allocate [20] percent of the receipts from a liquidating asset to income if, when the asset becomes subject to the trust or successive income interest, the trustee expects to receive payments from that asset for more than 5 years, or [10] percent if for 5 years or less, and shall allocate the balance to principal.

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

7 **Comment**

8 Section 11 of the 1962 Act allocates receipts from "property subject to
9 depletion" to income in an amount "not in excess of 5%" of the asset's inventory
10 value. It is essentially a provision to pay a fixed annuity to the income
11 beneficiary until the asset is exhausted. The balance of each year's receipts is
12 added to principal where it is reinvested and produces additional income. The
13 remainder beneficiary receives all of the receipts from unexpected growth.
14 Conversely, if the actual receipts diminish more rapidly than expected, most of
15 the payments will go to income and little to principal. Section 423 abandons the
16 annuity approach.

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

21 **SECTION 424. NATURAL RESOURCES.**

22 (a) If part of the principal consists of a right to receive royalties,
23 overriding or limited royalties, working interests, production payments, net profit
24 interests, or other interests in minerals or other natural resources in, on, or under
25 land, the receipts from taking the natural resources from the land must be
26 allocated as follows:

27 (1) If received as rent on a lease or extension payments on a lease,
28 the receipts are income.

29 (2) If received from a production payment, the receipts are income
30 to the extent that a factor for interest or its equivalent is provided in the contract
31 providing for the production payment. The fraction of the balance of the receipts

1 which the unrecovered cost of the production payment bears to the balance owed
2 on the production payment, exclusive of any factor for interest or its equivalent,
3 must be allocated to principal. Receipts not allocated to principal are income.

4 (3) If received as a royalty, overriding or limited royalty, or bonus,
5 or from a working net profit, or any other interest in minerals or other natural
6 resources, receipts not provided for in paragraphs (1) and (2) must be
7 apportioned for each accounting period in accordance with this paragraph
8 whether or not any natural resource was being taken from the land at the time the
9 trust was established. [20] percent of the net receipts is income. The balance is
10 principal.

11 (b) If, when this [Act] takes effect, a trustee holds an item of depletable
12 property of a type specified in this section, the trustee must allocate receipts from
13 the property in the manner used by the trustee before this [Act] takes effect, but
14 as to all depletable property acquired by a trust after this [Act] takes effect, the
15 method of allocation provided in this section must be used.

16 (c) This section applies to water, soil, sod, dirt, turf, mosses, and
17 similar assets.

18 Comment

19 The 1962 Act uses 27-1/2% as the depletion allowance. The Internal
20 Revenue Code no longer provides for a 27-1/2% depletion allowance, although
21 the major oil-producing States appear to have retained the 27-1/2% provision in
22 their principal and income acts (Texas amended its Act in 1993, but not this
23 provision). In the case of oil and gas property received from a decedent, the
24 proposed change will cause the depletion allowance to be based on cost depletion
25 in many cases; and cost depletion will be computed using the federal estate tax
26 value as the "cost."

27 Section 424 allocates 80% of the net receipts to principal and 20% to
28 income. A depletion provision that is tied to past or present Code provisions is
29 undesirable because it causes a large portion of the oil and gas receipts to be paid
30 out as income. As the wells are depleted, the amount received by the income
31 beneficiary falls drastically. Allocating a larger portion of the receipts to
32 principal creates a base of other income producing assets that will continue to
33 produce income when the mineral reserves are exhausted.

- 1
- 2
- 3
- 4
- 5
- 6
- 7
- 8
- 9
- 10
- 11
- 12
- 13
- 14
- 15
- 16
- 17
- 18
- 19
- 20
- 21
- 22
- 23
- 24
- 25
- 26

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

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

(c) Advance payments, minimum royalties and bonuses must be allocated to principal.

This is an initial pass on which comments have been solicited from several practitioners who represent trustees who own timber properties. An Oregon CPA has suggested we consider as an alternative the 80%/20% allocation used in Section 424 for oil and gas properties, and comments have also been solicited from practitioners about this suggestion.

33

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

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

6 (2) a regulated investment company, real estate investment trust,
7 investment partnership or similar investment entity;

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

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

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

16 (6) an insurance policy or its proceeds;

17 (7) a deferral asset; and

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

21 (b) If, before a beneficiary's income interest ends, unproductive
22 property is sold or exchanged for money and property that can be apportioned
23 easily, a portion of the net proceeds must be allocated to income to the extent that
24 the delayed income, plus the carrying charges paid from income during the
25 computation period, exceeds the net income required to be distributed to the
26 income beneficiary from the property during the computation period. The

1 balance of the net proceeds is principal. If unproductive property is sold on an
2 installment basis, the amount that is allocated to income under the preceding
3 sentence must be paid pro rata from the net proceeds received upon closing and
4 the deferred balance as it is received. If a mandatory income interest ends after
5 the sale or exchange but before the trustee receives all of the proceeds, the
6 delayed income other than the portion to be paid from installments is part of the
7 undistributed income.

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

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

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

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

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

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

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

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

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

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

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

Comment

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

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

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

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

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

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

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

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

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

8 Comment

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

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

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

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

1
2
3

4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21

22
23
24
25

[ARTICLE] 5
ALLOCATION OF DISBURSEMENTS DURING
ADMINISTRATION OF A TRUST

SECTION 501. DISBURSEMENTS FROM INCOME. A trustee shall
make the following disbursements from income:

(1) one-half of the trustee's regular compensation and that of the
trustee's agent;

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

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

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

Comment

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

SECTION 502. DISBURSEMENTS FROM PRINCIPAL.

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

(1) the remaining one-half of the compensation described in Section
501(1) and the expenses described in Section 501(2);

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

4 (3) principal payments of a trust debt;

5 (4) costs incurred to comply with applicable environmental laws,
6 and penalties imposed under those laws;

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

10 (6) insurance premiums paid on a policy not described in Section
11 501(4) of which the trust is the owner and beneficiary; and

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

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

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

21 Comment

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

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

28 Generation-skipping transfer taxes and the tax imposed by Internal
29 Revenue Code Section 4980A(d) (15% excise tax on excess retirement

1 accumulations, which increases the estate tax) are payable from principal under
2 subsection (a)(7).

3 **SECTION 503. TRANSFER FROM INCOME TO PRINCIPAL FOR**
4 **DEPRECIATION.**

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

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

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

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

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

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

25 (d) A method of depreciation more rapid than the straight-line method
26 may be used in some or all accounting periods if the trustee determines that the

1 straight-line method does not accurately reflect the rate at which an asset is likely
2 to deteriorate or become obsolete, but it may not be used solely because an
3 asset's market value declines.

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

6 Comment

7 The 1931 Act had no provision for depreciation. Section 13(a)(2) of the
8 1962 Act provides that "[t]he following charges shall be made against income: ...
9 a reasonable allowance for depreciation on property subject to depreciation under
10 generally accepted accounting principles" That provision has been resisted
11 by many trustees. Some do not provide for any depreciation on various grounds
12 including the argument that it is not needed to protect the remainder beneficiaries
13 if the land is appreciating, and the argument that generally accepted accounting
14 principles may not require depreciation to be taken if the property is not part of a
15 business.

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

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

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

34 **SECTION 504. TRANSFER FROM INCOME FOR PRINCIPAL** 35 **DISBURSEMENTS.**

36 (a) If a trustee makes or expects to make a principal disbursement
37 described in this section, the trustee may transfer, in one or more accounting

1 periods, an appropriate amount from income to reimburse principal or to provide
2 a reserve for future payments, including:

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

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

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

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

13 (5) costs incurred to comply with applicable environmental laws,
14 but:

15 (i) income may not be transferred to principal for penalties,
16 costs incurred to defend against the imposition of penalties, or any other
17 disbursement that does not contribute materially to the property's income-
18 producing ability;

19 (ii) a transfer from income to principal may be made only from
20 net income produced by the property for which the costs are incurred; and

21 (iii) the amount transferred may not exceed [20] percent of the
22 net income received from that property in any accounting period unless, based on
23 the amount of the trust's net income from all sources and other relevant
24 circumstances of the trust, the trustee determines that the amount to be
25 transferred should be more than [20] percent.

1 (b) A trustee may continue to transfer amounts from income to principal
2 as provided in this section when an income interest ends if the property becomes
3 subject to a successive income interest.

4 **SECTION 505. INCOME TAXES.**

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

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

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

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

15 (2) the tax resulted from the sale by the entity, other than in the
16 normal course of business, of a non-inventory fixed asset used in the entity's
17 business, or from the sale of an asset not used in the entity's business that would
18 be a principal asset if the trustee owned it directly, without regard in either case
19 to whether the entity has distributed any or all of the sales proceeds to the trustee.

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

22 (a) A trustee may make adjustments between income and principal as
23 the trustee considers appropriate to compensate for any shifting of economic

1 interests or tax benefit between income and remainder beneficiaries occurring
2 because:

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

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

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

11 (b) A trustee shall transfer from income to principal an amount equal to
12 the decrease in a marital deduction or a charitable contributions deduction that
13 occurs because the trustee elects under applicable federal or state law to deduct
14 on an income tax return instead of an estate tax return an amount that is paid
15 from or chargeable to principal, if the trustee's election causes an increase in the
16 estate tax and a decrease in the amount of principal that would be eligible for a
17 marital deduction or charitable contributions deduction.

1
2

3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25

[ARTICLE] 6
EQUITABLE ADJUSTMENTS

SECTION 601. TRUSTEE'S POWER TO REALLOCATE.

(a) If after applying the foregoing provisions of this [Act], the trustee determines that to comply with Section 102(a) it is necessary to reallocate between income and principal, the trustee may reallocate in whole or in part in such manner and in such proportions as the trustee determines.

(b) In exercising the power of reallocation, a trustee shall consider in addition to other relevant factors, such of the following factors, among others, as the trustee deems relevant to the trust or its beneficiaries:

- (1) the nature, purpose and expected duration of the trust;
- (2) the express intent of the settlor;
- (3) the identity and circumstances of the beneficiaries;
- (4) the actual and expected effect of economic conditions on principal and income and the possible effect of inflation and deflation;
- (5) the expected tax consequences of a reallocation;
- (6) the total return from investments;
- (7) needs for liquidity, regularity of income, and preservation or appreciation of capital;
- (8) the presence or absence of a power to invade principal or other dispositive provisions, that would reduce the importance of a reallocation, and the apparent reason for the presence or absence of such a provision; and
- (9) the assets held in the trust.

(c) The trustee may not make a reallocation pursuant to subsection (a) that would cause a loss, of all or part, of any federal or state gift tax exclusion,

1 gift or estate tax marital deduction, income, gift or estate tax charitable
2 deduction, or any inheritance tax deduction otherwise available to any estate or
3 trust or to the settlor of a trust or a decedent. In addition, a trustee shall not
4 exercise the power for the trustee's direct or indirect benefit, including the
5 satisfaction or mitigation of any legal obligation of the trustee; however, a
6 disinterested co-trustee may exercise the power.

7 (d) If a governing instrument limits the powers of a trustee to make
8 equitable adjustments, the instrument must not be construed to be contrary to this
9 section unless it is clear from the instrument that it is intended to deny the trustee
10 access to the power of reallocation.

11 Comment

12 **Purpose and Scope of Provision.** This section alleviates the tension
13 between modern rules for investing the assets held by a trustee and traditional
14 ideas about what constitutes the return on a portfolio. As to modern trust
15 investing, see the Uniform Prudent Investor Act (1994).

16 This section, also gives trustees the power to deal with extraordinary and
17 unanticipated situations and to overrule unjust results under the standard
18 provisions of the Act.

19 Section 3B:19A-32 of the New Jersey, Statutes which was passed by the
20 New Jersey legislature in 1991, allows the trustee faced with extraordinary and
21 unanticipated situations to reallocate. That section takes meaning from section
22 45a-219 (d) of the Connecticut Statutes.

23 This section allows the trustee to undertake the best, the most prudent
24 and totally most productive investment of all the trust assets without concern
25 about whether the investments chosen have the effect of impartially allocating the
26 investment return between the income and principal beneficiaries. Both income
27 and principal beneficiaries are entitled to proper return, and the allocation of that
28 return should not have to be a function of the particular assets chosen by the
29 trustee. This section also allows the trustee to follow the well understood
30 traditional system of allocating receipts and expenditures in many situations.

31 This section is not limited to the trustee who is a modern portfolio
32 theory investor.

33 If the trustee invests all the assets of a trust, taken as a portfolio, in a
34 way that will have an initially unsuitable effect without a reallocation of return
35 this section allows the trustee to reallocate. The power to reallocate receipts
36 spares the trustee from having to choose second best investments. This power

1 also allows the trustee to deal impartially and effectively with the effect of
2 inflation and deflation on investment returns.

3 The change -- giving a trustee the power to reallocate portfolio returns
4 between income and principal -- is less dramatic than it might first seem to be.
5 The prior Principal and Income Acts inferentially allowed a range of possible
6 returns for successive beneficiaries via asset choice and asset allocation. There
7 were a number of legally acceptable, impartial portfolios for any given trust that
8 would produce a variety of income and principal outcomes. Consider a
9 hypothetical world in which financial assets invested at a particular level of risk
10 could earn a total return of 8%. The trustee could prudently choose within a
11 universe of portfolios -- for example, a portfolio that provided 5% income and
12 3% growth or 5.5% income and 2.5% growth or 4.5% income and 3.5% growth.
13 So, the trustee always had the power to affect the return to beneficiaries.

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

17 **Taxes.** It is expected that reallocated income will be the income of the
18 trust under the law of any State adopting the Act. It is the intent of the drafters
19 that any capital gains realized to fund a reallocation payment to the income
20 beneficiary shall be allocated to the income beneficiary.

21 It is hoped the marital deduction will be available under this section of
22 the Act.

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

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

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

43 This section is subject to the injunctions in Section 102 of this Act
44 including the one that the trustee "shall be fair and reasonable to all of the

1 beneficiaries unless the governing instrument clearly manifests an intention that
2 the fiduciary must or may favor one or more beneficiaries." This section is also
3 subject to the limitations on fiduciary liability in Section 103.

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

8 **Examples.** The following examples demonstrate the function of the
9 reallocation approach in the context of modern investing:

10 **Example (1)** T is the trustee of a trust that provides income for a
11 surviving spouse for life, remainder to another. The trust portfolio is 60%
12 invested in a portfolio of stocks or mutual fund that seeks to replicate the
13 performance of the Standard & Poor's 500 and 40% invested in a bond
14 portfolio or mutual fund that seeks to replicate the performance of the U.S.
15 Bond Market as a whole. Trustee paid the traditional income attributable to
16 both funds to the income beneficiary. The trustee is justified in forgoing use
17 of the reallocation power because, historically, the traditional income return
18 on the Standard & Poor's 500 provides a stable, real return on equity
19 principal that is strongly correlated to the Consumer Price Index and because
20 a surviving spouse, can properly be understood as a primary object of the
21 settlor's bounty. Moreover, the traditional return on both parts of the
22 portfolio can be understood as a return that is within the range of appropriate
23 returns allocable to an income beneficiary.

24 **Example (2)** Having invested the entire trust in a stock portfolio
25 designed to replicate the performance of the Standard & Poor's 500 or in a
26 no-load, low-transaction cost mutual fund that passively invests in the stocks
27 in the Standard & Poor's 500 average, the trustee allocates in a traditional
28 fashion under the general terms of the Act. The trustee's objective was to
29 keep the income stream smooth and stable, even with inflation, and to
30 preserve the power of the portfolio to produce such a stream of income over
31 an extended period of time. The trustee expected that there would continue
32 to be a correlation between the dividends paid by the Standard & Poor's 500
33 and the Consumer Price Index. The trustee is justified in forgoing use of the
34 reallocation power because the traditional income return on the Standard &
35 Poor's 500 meets the stated goals. Moreover, the traditional return on the
36 portfolio can be understood as a return that is within the range of appropriate
37 returns allocable to an income beneficiary. See Twentieth Century Fund,
38 Task Force on College and University Endowment Policy, Funds for the
39 Future 122 (1975) (this is, in its essence, a monograph by J. Peter
40 Williamson); James P. Garland, A Market-Yield Spending Rule for
41 Endowments and Trusts, The Financial Analysts Journal, 50, 53 (July/Aug
42 1989). See also Robert H. Jeffrey, The Folly of Market Timing, Harv. Bus.
43 Rev., July-Aug 1984, at 102; Robert H. Jeffrey, A New Paradigm for
44 Portfolio Risk, J. Portfolio Mgmt., Fall 1984, at 33.

45 **Example (3)** Having invested in a portfolio that was 60% invested in
46 stocks or a mutual fund that seeks to replicate the performance of the
47 Standard & Poor's 500 and 40% invested in a bond portfolio or mutual fund

1 that seeks to replicate the performance of the U.S. Bond Market as a whole,
2 the trustee paid the traditional income attributable to the Standard & Poor's
3 500 fund to the income beneficiary, but capped the traditional income
4 attributable to the bonds, or bond fund, by reference to the Consumer Price
5 Index, adding the balance of the income earned by the bond fund to principal
6 in order to preserve the real value of the principal. The trustee's objective
7 was to keep the income stream smooth and stable, even with inflation, and to
8 preserve the power of the portfolio to produce such a stream of income over
9 an extended period of time. The trustee is justified in forgoing the power of
10 reallocation because the traditional income return on the Standard & Poor's
11 500 provides a stable, real return on equity principal that strongly correlates
12 with the Consumer Price Index. The trustee is justified in reallocating the
13 traditional income from the bonds, or bond fund, because Consumer Price
14 Index adjustments in payments are understood by many to be an appropriate
15 way for providing for a real return on bonds. See James P. Garland, A
16 Market-Yield Spending Rule for Endowments and Trusts, The Financial
17 Analysts Journal, 50 (July/Aug 1989).

18 **Example (4)** Having invested in a portfolio that was 60% invested in
19 stocks or a mutual fund that seeks to replicate the performance of the
20 Standard & Poor's 500 and 40% invested in a bond portfolio or mutual fund
21 that seeks to replicate the performance of the U.S. Bond Market as a whole,
22 the trustee paid the traditional income attributable to the Standard & Poor's
23 500 stocks, or fund, to the income beneficiary, but capped the traditional
24 income attributable to the bonds, or bond fund, at 3%, adding the balance of
25 the income earned by the bonds, or bond fund, to principal in order to
26 preserve the real value of the principal. The trustee's objective was to keep
27 the income stream smooth and stable, even with inflation, and to preserve the
28 power of the portfolio to produce such a stream of income over an extended
29 period of time. This was done during a period when there was a strong
30 correlation between the dividends paid by the Standard & Poor's 500 and the
31 Consumer Price Index. The trustee is justified in forgoing and reallocating
32 because the traditional income return on the Standard & Poor's 500 provides
33 a stable, real return on equity principal that historically correlates with
34 inflation and because 3% is understood by many as the historical real return
35 on bonds. Moreover, the traditional return on the equity part of the portfolio
36 can be understood as a return that is within the range of appropriate returns
37 allocable to an income beneficiary. See Twentieth Century Fund, Task
38 Force on College and University Endowment Policy, Funds for the Future
39 122 (1975) (This is, essentially, a monograph by J. Peter Williamson); James
40 P. Garland, A Market-Yield Spending Rule for Endowments and Trusts, The
41 Financial Analysts Journal, 50 (July/Aug 1989).

42 **Example (5)** Having invested in assets generating no traditional income,
43 the trustee chose to sell enough assets to generate a return for the income
44 beneficiary. In reallocating, the trustee chose to consider as a factor a
45 system used by some colleges and universities for determining current return
46 on endowment in determining trust income. In doing so, the trustee took
47 into account the different purposes, time horizons and tax exempt status of
48 such organizations and the potential for additional gifts lacking in a private
49 trust. T gave the income beneficiary an amount equal to 30% of 4.5 percent
50 of the principal of the trust plus 70% of the amount paid in the prior year to

1 the income beneficiary. This is a proper exercise of the power of
2 reallocation because it takes into account beneficiary expectations and the
3 inflation adjusted return on investments, and because it makes efficient and
4 proper use of the expertise of professionals who closely study the annual
5 return on investment assets. See Joel C. Dobris, Real Return, Modern
6 Portfolio Theory and College, University and Foundation Decisions on
7 Annual Spending From Endowments: A Visit to the World of Spending
8 Rules 28 Real Prop., Prob., & Tr.J. 49 (1993).

9 **Example (6)** Having invested in assets generating no traditional income,
10 in reallocating the trustee chose to consider as a factor the National
11 Association of College and University Business Officers (NACUBO) average
12 endowment spending rate for college and university endowments for the
13 previous year. In doing so, the trustee took into account the different
14 purposes, time horizons and tax exempt status of such organizations and the
15 potential for additional gifts lacking in a private trust. This is a proper
16 exercise of the power of reallocation because, among other things, it makes
17 efficient and proper use of the expertise of professionals who closely study
18 the annual return on investment assets. See Twentieth Century Fund, Task
19 Force on College and University Endowment Policy, Funds for the Future
20 122 (1975) (this is, in its essence, a monograph by J. Peter Williamson).
21 See also Robert H. Jeffrey, The Folly of Market Timing, Harv. Bus. Rev.,
22 July-Aug 1984, at 102; Robert H. Jeffrey, A New Paradigm for Portfolio
23 Risk, J. Portfolio Mgmt., Fall 1984, at 33.

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

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

1
2

3
4
5

6
7

8
9
10
11
12

13
14
15
16
17

18
19

[ARTICLE] 7
MISCELLANEOUS PROVISIONS

SECTION 701. UNIFORMITY OF INTERPRETATION. This [Act] shall be applied and construed to effectuate its general purpose to make uniform the law with respect to the subject matter of this [Act] among States enacting it.

SECTION 702. SHORT TITLE. This [Act] may be cited as the Revised Uniform Principal and Income Act (199__).

SECTION 703. SEVERABILITY. If any provision of this [Act] or the application thereof to any person or circumstance is held invalid, the invalidity does not affect other provisions or applications of this [Act] which can be given effect without the invalid provision or application and to this end the provisions of this [Act] are severable.

SECTION 704. REPEAL. The following acts and parts of acts are repealed:

- (1)
- (2)
- (3)

SECTION 705. EFFECTIVE DATE. This [Act] takes effect on

1 **SECTION 706. APPLICATION OF [ACT] TO EXISTING TRUSTS AND**
2 **ESTATES.** Except as expressly provided in the governing instrument or in this
3 [Act], this [Act] applies to any receipt or expense received or incurred by any
4 trust or decedent's estate after this [Act] takes effect.

