UNIFORM FIDUCIARY INCOME AND PRINCIPAL ACT (UFIPA)
SUMMARY OF CHANGES AND ISSUES IN THE JANUARY 22, 2018 DRAFT
(Substantive issues that the committee may discuss are in bold font.)

ARTICLE 1
DEFINITIONS, SCOPE, AND GOVERNING LAW

Section 101 – Short Title

No change.

Section 102 - Definitions

Paragraph (1). The definition of "accounting period" is cleaned up a bit (although it still doesn't explicitly refer to "52 or 53 weeks").

Paragraph (2)(A)(i) is modified to include current beneficiaries of principal and not income, who had been inadvertently omitted.

Paragraph (9)(A)(i). **Are we concerned that the word "entitled" (used twice here and 11 other times in the draft) is too noble, compared to "have a right" or "has a right"?** Meanwhile, "significant from the standpoint of voting control" (from section 672(c) of the Internal Revenue Code), is still omitted (**creating a tax trap?**), while subparagraph (C) is arguably broader, including, for example, the "issue" of a beneficiary ("spouse" is also added).

Paragraph (11). "If" is changed to "To the extent" and "includes" to "means" in the last sentence.

Paragraph (17). "Terms of the trust" is changed to "terms of a trust," to follow other uniform acts.

Paragraph (18)(B)(ii). The term "common trust fund" is omitted, on the advice of corporate fiduciaries that a common trust fund is typically treated as a trust.

Paragraph (19). "Any person, other than a personal representative, which owns or holds property for the benefit of beneficiaries" is added to the definition of "trustee."

Paragraph (20). "Or other amendment to a testamentary instrument" is added to the reference to a codicil.

Section 103 – Scope

No change.

Section 104 – Governing Law

No change.

ARTICLE 2
FIDUCIARY DUTIES AND JUDICIAL REVIEW

Section 201 – Fiduciary Duties; General Principles

Subsection (a). "Allocating" is changed to "making an allocation," making a determination and exercising discretion are added, and the scope of Articles 6 and 7 is expanded to the entire act. (In subsection (b), however, the specific mandate of impartiality, fairness, and reasonableness remains limited to the power to adjust, the power to convert to or change a unitrust, and "another discretionary power of administration." And consideration of the factors in subsection (c) is still limited to the power to adjust and the power to convert to or change a unitrust.)

Paragraph (2). The repudiation of a negative inference is added, although in fewer words than the model of the California Statute (section 16335) that was recommended, which adds "no inference that the fiduciary has improperly exercised the discretion arises from the fact that the fiduciary has made an allocation contrary to a provision of this chapter." The word "contrary" seems a bit harsh.

Paragraphs (4) and (5). Here, as well as in other places through the draft, references to "this [act]" are changed to "the other provisions of this [act]" and references to "to income or principal or between income and principal" are changed to simply "between income and principal." (It is possible that we could include a definition of "allocate" in Section 102, if it is permitted to define a verb. We would have to be careful, though, because the draft speaks of both a *fiduciary* allocating and a *rule* allocating; perhaps that itself flags a problem.)

Paragraph (5). The default for the allocation of disbursements is changed back to principal, as in the current uniform act.

Subsection (c). In the introduction to subsection (c), "the effect of allocations between income and principal on the fiduciary's ability to comply with subsection (b) after applying the rules in subsection (a)," previously in paragraph (7), has been promoted to a dominant consideration that is deemed "relevant." **The committee might decide that it is enough of a "promotion" to simply move that factor to the beginning of the list, making it paragraph (1).**

For the considerations of the supporting factors, however, the verb is still "shall," as in Section 104(b) of the current uniform act, not "may." **This was discussed at the November meeting and likely will be discussed again at the February meeting, but, in the absence of a compelling justification, it is hard to see how consideration of a factor that is "relevant" should be optional.** But the qualifier "relevant" is reworded as "all factors the fiduciary determines are relevant."

Paragraph (2). "Distribution standards" are added, but paragraph (8) [formerly (12)], addressing distribution standards with more particularity, is still included. "The intent of the settlor" (formerly paragraph (3)) is deleted as too subjective and unknowable, even though the "purpose … of the trust" is still retained in paragraph (2).

"The identity and circumstances of the beneficiaries" (formerly paragraph (4)) is deleted, although **the committee may not have fully considered whether it should be relevant, for**

example, whether trust remainder or successor beneficiaries are children of the grantor and the current beneficiary or children of only the grantor by another marriage.

Paragraph (3). In the reference to "the needs of the trust and the beneficiaries for liquidity and regularity of income," the words "of the trust and the beneficiaries" are deleted as the committee decided in November, but the word "needs" is also changed to "desirability," matching paragraph (4).

Paragraph (4). In the reference to the preservation of capital, the reference to indices is deleted, but references to inflation and deflation are retained in paragraph (10), albeit downgraded in effect to mere examples.

Paragraphs (5) and (6). Details about attributes of assets, formerly in paragraph (8), are deleted.

Former paragraphs (9) and (10) ("the net amount that would be allocated to income under [Articles] 4 through 7 to the extent they apply" and "the suitability of the rules in [Articles] 4 through 7 in the context of all the relevant factors considered by the fiduciary, including the other factors in this subsection to the extent they are relevant") are deleted as generally duplicative of the introduction to subsection (c) after the promotion of paragraph (7) as discussed above.

Subsection (d) ("A determination under this [act] is presumed to be fair and reasonable to all the beneficiaries."). This is unchanged and restored to its original position here at the end of Section 201 [Section 103 in the current uniform act], with the "factors" in subsection (c) [formerly in Section 104(b)] inserted ahead of it, partly so the committee can discuss it in its original 1997 context. **The issues include (i) shouldn't it say "in accordance with" rather than "under," (ii) what does it mean by "the [act]," (iii) why "fair and reasonable" rather than "in good faith," "impartial," "not an abuse of discretion," or something else, (iv) for what purposes does this "presumption" apply, and (v) what does it mean anyway?**

Section 202 – Judicial Review of Discretionary Power

Subsection (a)(1) is added to define a "fiduciary's decision," which makes the rest of the section more readable.

Subsection (a)(2) elaborates the meaning of the use of the word "trust," which is usually avoided in this draft, but at some points (as in subsection (d)(2) and (3)) it is awkward to try to avoid it.

Throughout Section 202, "allocations" and "determinations" are added to the exercise or nonexercise of discretionary powers, to conform to Section 201(a). In addition, "shall" is changed to "may" when referring to a court, and the distinction between "income" and "remainder" beneficiaries is dropped as redundant.

Former subsection (a) is divided into two subsections – (b) and (c) – so that the deference rule in subsection (c) can be carved out in referring later (Section 203(g)) to court review of a proposed adjustment by an interested trustee.

Subsection (d). The elaboration of certain remedies is retained to help judges, especially nonspecialist judges. The phrase "in addition to other remedies provided by this [act] or otherwise" is added. **Do the particular rules for adjustments and unitrust conversions in Sections 203(c) and 302(f) work with the revised Section 202(d)?**

Section 203 – Fiduciary's Power To Adjust

<u>Subsection (b)</u> is moved up from the end of the section and is expanded to disavow a duty to *consider* adjustment.

<u>Subsection (c)</u> is also moved up from the end of the section. **It still adopts a standard of good faith and still applies to both inaction and action. Does it work with Section 202(d)?**

<u>Subsection (e)</u>. The introduction cites subsection (a) to make it clear that these limitations apply only to the general power to adjust under Section 203 and not, for example, to the specific "equitable adjustment" powers under Section 506.

<u>Paragraphs (1) and (2)</u>. These tax-sensitive limitations are relaxed "to the extent the adjustment is made to provide for a reasonable apportionment of the total return of the trust," which tracks a safe harbor in Reg. §1.643(b)-1.

<u>Paragraph (5)</u>. The words "and the person would not be treated as the owner if the fiduciary did not possess the power to make an adjustment" are deleted because they seem duplicative of the expression "*causes* a person to be treated as the owner of all or part of the trust for federal income tax purposes."

<u>Paragraph (6)</u>. A deletion similar to paragraph (5) is made. Also, paragraph (6) is limited to estate tax consequences for the estates of individuals *who have the power to remove or appoint a fiduciary*. This is an unusual limitation, and the reason for it might not be apparent. **But to delete it without further study and consideration might create the anomaly that almost anything the fiduciary could do might be prohibited, because, for example, *every* distribution to a beneficiary arguably increases that beneficiary's gross estate.**

<u>Paragraph (7)</u>. This is added to provide comparable safeguards for gift tax purposes too, but again **this creates the possibility of being overbroad and thus unreasonably limiting**. Meanwhile, the former paragraph (8), prohibiting a fiduciary from acting if the fiduciary is a beneficiary, is deleted because that concept is entirely subsumed in the prohibition in paragraph (9) if the trustee is not an "independent person," which is defined to include beneficiaries.

<u>Paragraph (8)</u>, which was new in November, is an adaptation of New York's EPTL § 11-2.3(b)(5)(C)(viii). **Questions that remain are (i) whether it's a good idea; (ii) whether it needs to be so detailed; (iii) whether the wording is otherwise appropriate; and (iv) whether it should be limited to trusts for settlors.**

<u>Subsection (f)</u> is expanded to allow for an adjustment to be made not only by an existing co-fiduciary but by a co-fiduciary appointed upon that occasion, although this draft does not restrict that appointed co-fiduciary to the adjustment role – *e.g.*, as a "special trustee." The first sentence of the Legislative Note is added as a precaution, in case state law requires trustees to act unanimously.

<u>Subsection (g)</u> is added to permit a trustee who is a beneficiary or otherwise non-independent to still exercise the power to adjust by following the procedures set forth in Section 303 for actions regarding unitrusts. In any ensuing court proceeding, the rule of Section 202(c) that "a fiduciary's decision is not an abuse of the fiduciary's discretion merely because the court would have made a different decision" does not apply, on the ground that the decision of an interested or non-independent fiduciary is entitled to less deference.

<u>Subsection (h)</u> is expanded to include delegation as well as release.

<u>Subsection (i)</u>. The standard of "clear … that the terms are intended to deny" is replaced by the more objective standard "expressly deny" borrowed from Section 15 of the Uniform Trust Decanting Act.

<u>Subsection (j)(1)</u>. The former omission of any power to adjust *during* the accounting period to which it applies is corrected. As currently drafted, subsection (j) permits an adjustment for any given accounting period to be made in the next accounting period, but does not allow any greater retroactivity than that. For example, an adjustment could be made in year 10 that applies to income and principal items received or paid in year 9 (but not earlier), as well as years 11, 12, and so forth. **It may be appropriate to require the year 9 adjustment to be made earlier in year 10, such as the first 65 days (corresponding to the distribution look-back in section 663(b) of the Internal Revenue Code) or the first 105 days (corresponding roughly to the due date of individual federal income tax returns) or some other time such as the first six months or the first nine and one-half months (corresponding roughly to the extended income tax return due date). Such a change would be a bit arbitrary and somewhat more complicated, but certainly not impossible.**

ARTICLE 3
UNITRUST

Section 301 – Definitions

<u>Paragraph (2)</u>. An "express unitrust" is now defined here.

<u>Paragraph (3)</u>. "Noncontingent" is added to the reference to liabilities.

Section 302 – Application of Article; Duties and Remedies

<u>Subsection (b)(2)</u>. The application of this article is extended to an express unitrust, which is now the case in about 19 states.

<u>Subsection (d)</u> elaborates the way this article applies to an estate.

<u>Subsections (e) and (f)</u>, regarding duties and remedies, which had been buried in Section 310 at the end of the article, are now moved up here, to provide more clarity.

<u>Subsection (f)</u> still adopts a standard of good faith and still applies to both inaction and action. Does it work with Section 202(d)?

Section 303 – Authority of Fiduciary

Subsection (d). The right of qualified beneficiaries to convert to a unitrust if the fiduciary refuses to do so has been deleted. Apparently only two states, Alabama and Washington, permit that. But a beneficiary, perhaps anomalously, is still permitted to petition the court under subsection (b) (in addition to subsection (d)).

Subsection (f). The right to delegate, as well as release, the unitrust conversion power is added.

Section 304 – Notice

For ease of reading, two versions of Section 304 are provided, one for states with the UTC and one for states without the UTC.

In subsection (d)(4) of Alternative A and subsection (c)(4) of Alternative B, the description of the due date of a beneficiary's objection is changed from "must be made" to "must be received by the fiduciary," to conform to Section 303(b).

In subsection (d)(6) of Alternative A and subsection (c)(6) of Alternative B, "mailing address" is changed to "contact information." Conforming changes are made to paragraph (3) of that subsection ("sending" instead of "mailing") and in the previous subsection (adding "sent").

Section 305 – Unitrust Policy

Subsection (b)(1) and (2). The words "determination of" are changed to "method for determining."

Subsection (b)(3) is added to provide that even rules that are optional under Sections 306 through 309 must be set forth in the written policy to the extent the fiduciary elects such rules. This addresses the concern that because a couple of the subsections in Section 306 through 309 begin with "must" and the rest begin with "may," it is possible that if the fiduciary decides to adopt any of the optional standards and methods, those standards and methods adopted "may" but need not be stated in the unitrust policy.

Section 306 – Unitrust Rate

No change.

Section 307 – Applicable Value

Subsection (c)(1) and (2). The references to "applicable values" are changed to "fair market values."

Subsection (c)(5). The reference to "financial features" is changed to "features of an asset which affect value."

Section 308 – Period

No change.

Section 309 – Other Rules; Special Tax Benefits

Subsection (c). The identification of the provisions still applicable in the case of a "special tax benefit" trust has been updated, mainly by reason of more time to check the cross-references.

No "ordering rule" has been added. In particular, nothing has been added relating to the allocation of capital gains to income for federal income tax purposes. This Article 3 (along with Section 203) plus the last substantive sentence of Reg. §1.643(b)-1 arguably already accomplish this. Although the draft does include many federal tax guardrails for these income and principal rules, there is no provision yet that purports to grant federal tax election authority.

ARTICLE 4
ALLOCATION OF RECEIPTS DURING ADMINISTRATION

PART 1 – RECEIPTS FROM ENTITIES

Section 401 – Character of Receipts from Entities

"Entities" is now included in the title of the section, as well as in the title of the part.

Subsection (a)(1). The last sentence provides a one-time statement that the relationships and actions addressed by this section include both "direct" and "indirect" (that is, through other entities).

Subsection (a)(2). The special-purpose definition of "distribution" is now changed to "entity distribution," and is clarified to be limited to payments made to an owner in the owner's capacity as such – not, for example, in the owner's capacity as employee, lender, or landlord.

Subsection (c)(1)(B). There is still an exception from the principal allocation for "personal property of nominal value." "Nominal" may be a more typical word for this kind of use, and thus less troublesome, than the previous reference to "insubstantial or immaterial." What is in view here, for example, is a fruitcake a corporation sends its shareholders at Christmas.

Subsection (c)(2)(B). **The "liquidation" standard of former subsection (c)(3) is changed to what "the fiduciary determines to be a return of capital."**

Subsections (c)(2) and (g). Addressing concerns about how the fiduciary will know the things necessary to know to apply these rules, with reference to a series of related distributions subdivisions (c)(2) and (g) employ the term "known to the fiduciary or provided to the fiduciary by or on behalf of the entity." **The Comments might include examples.** Other information the fiduciary should know is described as "in the fiduciary's possession" in subsection (k)(1) or, with respect to information learned later, "the fiduciary receives" in subsections (l) and (m).

Subsections (e)(1) and (2). References to "business" are expanded to "business or other activity," as in subsection (a)(1), to be consistent with Section 403.

Subsection (g). **The 20-percent test, which has been a challenge for the committee, is**

retained (but as a permissive safe harbor, not a presumption).

Subsection (h)(1). **The "characterization by the entity" test is included here at the head of the list of considerations (but also as only a permissive safe harbor, not a presumption).**

Subsection (h). **As most of the tests or factors in subsection (h) refer to accumulations and other events that could occur over an historical time period, this draft adopts the three previous years to define that time. This is adapted from a recommendation that the time be the *longer* of three years or the fiduciary's tenure; the committee might discuss this.**

Subsection (h)(3). **The term "governing body" is still used, even though it is vague and awkward. It is a holdover from the term "board of directors" in Section 401(f) of the current uniform act.**

Subsection (j) is completely rewritten to eliminate redundant or superfluous timing options, although it is now less ready-friendly. To illustrate, reliance on what the entity provides is expressly reaffirmed in subsection (j)(1) if it is received within a month after the end of the fiduciary's accounting period in which the end of the entity's accounting period in which the entity distribution is made occurs. In other words, if the entity uses a fiscal year ending September 30 and makes a distribution in November 2018, and the fiduciary uses a calendar year, then the fiduciary may rely on information provided by the entity by January 31, 2020 – the distribution is made in the entity's fiscal year ending September 30, 2019, which is in the fiduciary's year 2019, which ends December 31, 2019, and one month later is January 31, 2020. If the fiduciary doesn't know the entity's fiscal year, then subsection (j)(2) permits the fiduciary to look only at the fiduciary's own year. In that case, the time for relying on information in the example ends January 31, 2019 – the distribution is received in the fiduciary's year 2018, which ends December 31, 2018, and one month later is January 31, 2019. One rationale is that by the end of January a K-1 or 1099 or other statement from the entity might have revealed not only the required information but also the identity of the entity's fiscal year. **If that seems a little quick, we might change one month to something like two months. We also might give up the use of the entity's fiscal year altogether, although it can be relevant to the year in which the fiduciary includes the distribution in income for income tax purposes, which always is an occasion for sharpening a fiduciary's focus.**

Section 402 – Distribution from Trust or Estate

The former reference to "a purchased interest" is clarified as "an interest the fiduciary purchased."

Section 403 – Business and Other Activities Conducted by Fiduciary

Subsection (b). The word "may" is changed to "shall." It seems hard to imagine what "accounts separately" means without "separate accounting" (even if it is quite informal), and "accounts separately" is the predicate for subsection (c). Segregation of assets is still optional.

Subsection (d)(7). "Activities to which Section 413 applies" (derivatives and options) is still enumerated as an example of an activity for which a fiduciary may maintain separate accounting records. This is carried over from Section 403(c)(7) of the current uniform act, where it is not explained. In contrast, Section 414 (asset-backed securities) is omitted, as it is in the current uniform act. **Should Section 414 and new Section 415 (other financial instruments and arrangements) be added? (Paragraph (8) still includes "other *operating* businesses," and "assets" is not added to "activities" in subsection (d)(7) as it is in Section 409(a).)**

PART 2 – RECEIPTS NOT NORMALLY APPORTIONED

The tile of Part 2 was "Receipts Not Normally *Allocated*." The parallel title of Part 3 was "Receipts Normally *Apportioned*." This draft goes with "Apportioned" and changes the title of Part 2.

Section 404 – Principal Receipts

Paragraph (3). The reference to "disbursements described in Section 502(a)(7)" (relating to environmental matters) is retained from the current uniform act. It is not clear why the act singles out that provision, but it does add "or for other reasons…," so the limitation seems harmless.

Section 405 – Rental Property

No change.

Section 406 – Receipt on an Obligation To Be Paid in Money

Subsection (a). Section 415 (the "catch-all" financial instruments section we have added) is added to the list of exceptions, otherwise carried over from the current uniform act.

Section 407 – Insurance Policies and Similar Contracts

No change.

PART 3 – RECEIPTS NORMALLY APPORTIONED

Section 408 – Deferred Compensation, Annuities, and Similar Payments

Former subsection (a), saying that Section 408 does not apply if Section 409 applies, is deleted. The reverse point is now made in a new subsection (a) in Section 409. The defined application of Section 408 has seemed appropriate to commenters.

The details guiding the fiduciary's case-by-case determinations and decisions in former subsections (c) though (e) are deleted, leaving what is basically a strict fund-by-fund passthrough rule.

Subsection (c). The safeguards for "see-through" trusts for IRAs and possibly other retirement benefits held for surviving spouses are preserved, but without regard for the marital deduction predicate that had been in the former subsections (f) and (g), which are deleted. **The reference to allocation to income at the end of current subsection (b) and the introduction to the surviving spouse at the beginning of current subsection (c) (which has been separated from subsection (b)) are added to "fill the gap" left by the deletion of former subsections (c)**

through (g). The committee should consider how effective these proposed fill-ins are.

This draft does not accommodate the technique that has been discussed in some circles of permitting a trustee to satisfy the requirement of distributing the IRA's "internal income" to the spouse by use of other trust assets, thereby allowing at least some of that income to be held in the IRA where it can continue to grow tax-free.

Section 409 – Certain Illiquid Assets

Subsection (a) is added to state that this section does not apply if Section 408 applies, conforming to the deletion of the reverse provision from Section 408.

Subsection (b). "Asset" is added to "activity" in describing the subject of Section 413, and Section 415 (the "catch-all" financial instruments section we have added) is added to the list of sections.

Subsections (c) and (d). The 10 percent rule is retained, but as a default rule, not mandatory as in the current uniform act.

Section 410 – Minerals, Water, and Other Natural Resources

Redundant verbiage at the beginning – basically saying that this section applies if this section applies – is deleted.

The rest of the section is borrowed from the Texas statute commended to us by Mickey Davis. It is similar to the current uniform act, except that it does not provide for a default 10 percent allocation to income, but provides that the allocation should be made "equitably," and then provides, in subsection (d), that an allocation to principal of the amount allowed by the Internal Revenue Code as a depletion deduction is presumed to be equitable. For oil and gas percentage depletion, that percentage was most recently set at 15 percent, and Mickey confirms that virtually all Texas trustees use an 85-15 allocation. Thus, as an allocation to income, this change replaces a 10 percent default rule with an 85 percent safe harbor. Subsection (e) is retained and will protect any fiduciary who is currently relying on the 10 percent rule. Cost depletion for federal income tax purposes is also available as a safe harbor.

Section 411 – Timber

As in Section 410, redundant verbiage at the beginning – basically saying that this section applies if this section applies – is deleted.

There are no other changes.

Do we need to specifically address agriculture?

Section 412 – Marital Deduction Property Not Productive of Income

Subsection (a). The word "if" is changed to "to the extent."

Section 413 – Derivatives and Options

This revision is based on a draft Paul Lee provided. Paul also provided the following commentary, including his question at the end about whether corresponding amendments should be made to Section 414 (Asset-Backed Securities) and Section 415 (Other Financial Instruments and Arrangements), as to which we have encouraged him to proceed:

> Previous law provided that all receipts and disbursements from a derivative and option must be allocated to principal.
>
> The definition of “derivative” is meant to include some of the most common derivatives today, including: (1) options, which provide one party the right but not the obligation to buy or sell the underlying asset at a set price, (2) forwards and futures contracts, which obligate one party to buy or sell the underlying asset at a set price in the future, and (3) swaps (sometimes referred to as “notional principal contracts”), which obligate both parties to the arrangement to make payments to the other party based upon the change in value of an underlying asset or the occurrence of an event. The definition is meant to be broad enough to include less common derivatives like exchange-traded notes (financial instruments traded on an exchange, the value of which is linked to the return of a hypothetical investment in a specified market index or strategy), structured or principal-protected notes (financial instruments typically issued by a financial organization that provide the holder some principal protection along with a return based upon the return of an underlying asset like a stock index), and derivatives that could be created in the future. The definition does not make a distinction between derivatives that are privately negotiated arrangements between a party and counterparty and those that are traded on an exchange or in the over-the-counter market. Although options technically fall within the definition of derivative, as with the previous law, a specific subsection makes clear that any amounts paid to or received by the fiduciary in the granting of an option and any gain or loss upon any realization or expiration event will be allocated to income and principal in the same manner.
>
> The committee considered a provision that would have asked the fiduciary, in allocating receipts or disbursement under a derivative contract to income or principal, to consider how they would be allocated if the fiduciary had invested directly in the underlying asset that is the subject of the derivative. For example, if a fiduciary entered into a total return equity swap on shares of ABC stock, pursuant to which the fiduciary will receive payments from the counterparty due to any dividends and appreciation on ABC stock, then it bears to reason that the fiduciary should allocate to income that portion of the return that is due to dividends and to principal that portion of the return that is due to appreciation on ABC stock. However, that sort of determination only works under the simplest of derivative arrangements. Derivatives allow parties to take positions in assets that would not be possible under an established market and to make highly leveraged investments in assets that would not be permitted under current margin regulations. Furthermore, derivatives are sometimes combined in such a way that looking through to the underlying asset is difficult or impossible. For example, a “swaption” is an option

that provides the owner the right to enter into a swap. Due to these complications, the committee recommends a default rule that provides that all receipts and disbursements in relation to a derivative transaction should be allocated 10% to income and 90% to principal. No distinction is made if the fiduciary establishes a long (generally seeking to profit from an increase in value of the underlying asset) position or short position (seeking to profit from a decrease in value of the underlying asset) with the derivative.

This default allocation for derivatives can be adjusted pursuant to the fiduciary's power to adjust under Section 203 of the Act. In making that determination, the fiduciary can consider whether the default rule would not be fair and reasonable especially in light of the fact that derivatives can be used to create the equivalent return as another investment, whose allocation under the Act might be different than the default rule. For example, in a traditional total return equity swap, one party (Party S, for short) agrees to make annual payments over the next 5 years in an amount equal to the sum of the total appreciation in value of 100 shares of XYZ stock during the year, and dividends paid on 100 shares of XYZ stock during the year. The counterparty (Party L, for Long) agrees to make 5 annual payments (at the same time) in an amount equal to the total depreciation in value of 100 shares of XYZ stock during the year, and a fixed rate of interest multiplied by the value of 100 shares of XYZ stock at the beginning of each year. The amounts are netted against each other. From an economic standpoint, Party L is in the same situation it would be if Party L had borrowed funds from Party S and used those proceeds to buy 100 shares of XYZ shares from Party S, with an agreement to sell the shares back to Party S at the end of the 5 year period (100%-leveraged investment in 100 shares of XYZ shares). Furthermore, the fiduciary should consider whether the derivative is being used as a way to hedge or manage risk on another investment, and as such, any receipts or disbursements on the derivative should be combined with the hedged investment. For example, an investor may have an investment (ABC stock) and use a derivative to hedge against a decrease in the investment's value (buy a put option on ABC stock). The fiduciary should consider whether the cost or return on the put option is properly combined with the cost or return on ABC stock in applying the default rule hereunder or making any adjustments to income or principal as to ABC stock. By way of another example, the most common swap arrangement is an interest rate swap, pursuant to which parties help manage the impact of changes in interest rates on investments in the portfolio and liabilities associated with loans. In a common interest rate swap (floating-to-fixed rate), one party agrees to make payments based on a fixed interest rate (for example, 5%) applied to a notional amount (for example, $1 million) at regular intervals (for example, quarterly for 2 years). The counterparty agrees to make interest payments based on a floating or variable rate of interest (for example, 3% above the London Interbank Offered Rate [LIBOR]) applied to the same notional amount. An interest rate swap like this can reflect one party's expectation that the payments of a floating interest rate will exceed a specified fixed interest rate (or vice versa). Importantly, to the extent such party has a loan or other liability tied to a floating interest rate, the party might be seeking to hedge against the risk of an interest rate increase by essentially converting the liability to a fixed rate liability. In deciding whether to use the default rule hereunder or exercising the power to adjust, the fiduciary may decide, if appropriate, based on the facts and circumstances, to apply the default rule as to the interest rate swap in isolation or as part of a larger transaction where the swap is should be considered in conjunction with a larger transaction, liability, or investment.

Editorial Notes

Should options have a separate subsection?

Should corresponding amendments be made to Section 414 (Asset-Backed Securities) and Section 415 (Other Financial Instruments and Arrangements)?

Section 414 – Asset-Backed Securities

No change. But Paul Lee is looking at it.

Section 415 – Other Financial Instruments and Arrangements

No change. But Paul Lee is looking at it.

Section 416 – Insubstantial Allocations Not Required

The reference to Section 203(h) is expanded, as is Section 203(h) itself, to include delegation as well as release.

ARTICLE 5
ALLOCATION OF DISBURSEMENTS DURING ADMINISTRATION

Section 501 – Disbursements from Income

Little change.

Steve Gorin suggested an exception for QSSTs. That change has not been made, but should be discussed.

In the context of Section 203(f), we also may be considering the desirability of adding a power in an interested or disqualified fiduciary to appoint an independent person to take some actions the fiduciary cannot take. The power in paragraph (2) of Section 501 regarding paying more than 50 percent of trustee's fees, etc. out of income "because principal is illiquid or otherwise" is another example. (Paragraph (2) might become paragraph (2) of subsection (a) if a new subsection (b) is used to provide this power to appoint an independent person.)

In any event, Comments should offer options, such as "borrowing" from principal and exercising the power to adjust.

Paragraph (3) refers to "expenses of a proceeding or other matter that concerns primarily the income interest." Section 502(a)(4) (presumably the parallel of section 501(3)) refers to "expenses of a proceeding that concerns primarily principal." **Why should Section 501(3)**

include "or other matter" while Section 502(a)(4) does not? And are we "concerned" about using the word "concerns" as a verb this way? These are the only two places it is used, although "concerning" is used three times (twice in Section 302(c) and once in Section 403(c)(2)).

Section 502 – Disbursements from Principal

<u>Subsection (a)(4)</u>. See the paragraph immediately above about the phrase "or other matter" and the verb "concerns."

<u>Subsection (a)(5)</u>. A reference to title insurance is added.

<u>Subsection (a)(6)</u>. **Should "estate, inheritance, and other transfer taxes" be changed to "estate and inheritance taxes and other taxes imposed by reason of the death of a decedent" as in Sections 601(c)(2) and (3)? Is it clear that gift taxes are not meant to be included?**

Section 503 – Transfers from Income to Principal for Depreciation

<u>Subsection (a)</u>. The modifier "fixed" is removed from "asset."

Section 504 – Transfers from Income to Reimburse Principal

No change.

Section 505 – Taxes on Income

The title is changed from "Income Taxes" to "Taxes on Income." Some potential grammatical problems (fused participles) in subsections (a) and (b) are avoided, and former paragraphs (1) through (3) in subsection (c) are combined into a single paragraph (1).

Section 506 – Adjustments Between Income and Principal Because of Taxes

Former subsection (c) is deleted. It said the same thing as Section 505(d).

The third word of the section is still "may" and is not changed to "shall" as some have advocated to give "equitable adjustments" the dignity they deserve. (The current uniform act uses "may.") While "may" appears to lessen the pressure on fiduciaries, we all recognize that a power could become an obligation – "may" could mean "must" – if the fiduciary duty of impartiality would be strained by a tax election or decision that tilts the tax burden from one set of beneficiaries to another.

Also, notice that subsection (b) is mandatory, and is very specific, perhaps unworkably specific.

Consideration might be given to simply deleting all of Section 506 and adding a reference to equitable adjustments because of taxes in Section 203 (Power to Adjust). That, in effect, would solidify the use of "may," but still with the same fiduciary considerations.

ARTICLE 6
DEATH OF DECEDENT OR TERMINATION OF INCOME INTEREST

Section 601 – Determination and Distribution of Net Income

Subsection (a)(1). The words "After a decedent dies" are retained, even after the lively (so to speak!) discussion at the November meeting about whether it is possible for a "decedent" to "die." The "death of a decedent" is a term with widespread use and acceptance.

Meanwhile, the new title of Article 6, "Death of Decedent or Termination of Income Interest," describes the two common events that could create the need for this kind of temporal allocation. This is an improvement over the title of Article 2 in the current uniform act, "Decedent's Estate or Terminating Income Interest," which is flagrantly non-parallel. But the two notions are elaborated in a somewhat expanded subsection (a).

Subsection (b). The word "who" is changed to "that" in the last sentence because the "beneficiary" may not be an individual – may be a trust or a charitable organization, for example.

Subsection (d). The first occurrence of the term "interest or other amount" in the second sentence is expanded to "payment of interest or other amount." A Comment should clarify that this subsection does not mean that the terms of a will or the provisions of statutes like the Uniform Probate Code that govern the administration of estates are necessarily imported into the terms of ongoing trusts.

Otherwise, Article 6 seems harmless and has not attracted a lot of comment.

Section 602 – Distribution to Residuary and Remainder Beneficiaries

The only change is to delete the unnecessary phrase "including assets that later may be sold to meet principal obligations" at the end of subsection (b)(1).

ARTICLE 7
APPORTIONMENT AT BEGINNING AND END OF INCOME INTEREST

Section 701 – When Right to Income Begins and Ends

Subsection (a). "A current income beneficiary or successor beneficiary" is changed back to just "An income beneficiary," as in the current uniform act. The extra words seemed unnecessary. But the qualifier "in accordance with the terms of the trust" is added to make it clear that the inquiry must start with the terms of the trust, which is where "current" and "successor" standings originate anyway.

This raises the question of whether "income beneficiary" needs a definition. ("Income beneficiary" is actually used in defining "beneficiary" in Section 102(2)(A).)

Subsection (b)(2). "By reason of a will" is changed to "by reason of the death of a decedent." This gets around the fact that a lot of "testamentary" provisions are now included in trusts. It is also consistent with the use we have made of the phrase in Section 601(c)(2) and (3) where we were trying to find a synonym for "death taxes."

Subsection (d). "Whom" is changed to "which" in the last line to comply with ULC style conventions.

Section 702 – Apportionment of Receipts and Disbursements When Decedent Dies or Income Interest Begins

No substantive change, but the entire section is rewritten and the subdivisions revised for clarity.

Section 703 – Apportionment When Income Interest Ends

No substantive change, but the entire section is rewritten and the subdivisions revised for clarity.

ARTICLE 8
MISCELLANEOUS PROVISIONS

Former Section 803, providing transitional relief from the 2008 amendments applicable to spousal IRAs, is deleted. It is unnecessary in light of the simplification of Section 408 in this draft.

There are no other changes to Article 8.