Memorandum

From: Turney P. Berry, Chair
David J. Clark, Vice Chair
Ronald D. Aucutt, Reporter

To: Uniform Law Commission

Re: Uniform Fiduciary Income and Principal Act
Formerly the Revised Uniform Principal and Income Act

Date: June 13, 2017

This Memorandum reviews the Uniform Fiduciary Income and Principal Act (UFIPA), which is slated for a first reading at the upcoming 2017 Annual Meeting in San Diego. Additional attention is directed to the Comments to the draft Act.

Background. The allocation of receipts and disbursements between the income and principal accounts, or beneficiaries, of a trust is a fundamental necessity for orderly, efficient, and fair trust administration. The Uniform Law Commission promulgated acts dealing with this important matter in 1931, 1962, and 1997. Subsequent to 1997, various amendments have been adopted such that the current ULC Act is referred to as the 2000 Act, with subsequent 2008 Amendments.

Our principal and income acts have been widely adopted. Currently, all but a handful of states have some version of a ULC principal and income act. We should all feel great pride in the widespread uniformity of law created by the ULC's work over the past 80+ years. However, that same widespread uniformity produces habits and customs that resist modernization.

How the Act Works. The current revision of the former Uniform Principal and Income Acts, like the 1997 revision, is intended to reflect and address changes in the design and use of trusts. Although traditional trusts with designated income and remainder beneficiaries, perhaps allowing principal distributions to either or both upon certain terms and conditions, continue in existence and continue to be created, we also see very long-term trusts becoming increasingly common, as well as totally discretionary trusts – that is, trusts in which income, as well as principal, is distributable to beneficiaries during the term of the trust not necessarily as a matter of right but only in the discretion of the trustee. Even where income distributions are mandatory, including occasions where income distributions are mandated by requirements of tax law (such as the federal estate tax marital

deduction), discretion in the trustee to supplement income distributions by invasions of principal are common.

One result of these developments in the design, use, and role of trusts is to make historical distinctions between income and principal less important as a technical matter. Discretionary accumulation of income has the effect of treating income as principal to the extent of the accumulation. And discretionary invasion of principal has the effect of treating principal as income to the extent of the invasion. Even so, the difference between income and principal is important to impartial trustees and beneficiaries alike. If nothing else, the history of distinctions between the tree and its fruit and between the herd and the calf have created a dignity and discipline that are relevant in the administration of even a totally discretionary modern trust.

Thus, the Drafting Committee has chosen to retain the historical distinctions, including the historical technical rules that have evolved through changing legal and practical environments, while still allowing skilled and dedicated trustees the ability to respond and act appropriately in legal and practical environments that inevitably will continue to change. Indeed, the trustee and estate planning communities demanded that we not remove the default rules for fear that we would leave trustees, beneficiaries, and planners all at sea.

Nonetheless, although the current act retains default allocations of receipts and disbursements, those are not the core of the act. Rather, the basic premise of the current revision is that a trustee that is aware of the current practical environment of trust administration and sensitive to the evolving demands of impartiality should be able to determine standards for adjusting between income and principal that are reasonable in the circumstances, and to update those standards from time to time.

Authority to make adjustments between income and principal from year to year, introduced as Section 104 in 1997, is retained, and indeed significantly expanded, as new Section 203. The most important way in which the authority to adjust is expanded is by eliminating the precondition that trust distributions are constricted by the concept of "income" in a way that economic results from year to year could arbitrarily affect. In other words, while the trustee of a more modern trust with greater, if not total, flexibility to make distributions from income and/or principal would actually have been *denied* the flexibility intended by former Section 104, new Section 203 would ensure that designing a trust for greater flexibility would not ironically sacrifice the flexibility of adjustment.

This is how the current Act respects, and permits a trustee to respect, the historical dignity and discipline of the simple notion of "income." Under Section 203, a trustee of a discretionary trust can make adjustments, taking into account a

nonexclusive list of factors provided in Section 201(c), and still achieve the comfortable outcome of "distributing income." And when the interests of beneficiaries under the terms of the trust are still not appropriately served within the framework of "distributing income" – that is, when no reasonable adjustment would serve those interests, or when significant non-pro rata distributions are justified – then invasions of principal are still appropriate to the extent consistent with the terms of the trust.

A trustee that does not make adjustments under Section 203 still has the option of following the more traditional rules, which are retained, with modest updates, in Articles 4 through 7.

Unitrust Conversion. A special word is required about Article 3, which allows the conversion of a trust to a unitrust. That conversion could be thought of as the "ultimate adjustment." Rather than pay any attention to the character of receipts or disbursements, the trustee simply allocates to income a percentage of the fair market value of the trust. In principle, all trust beneficiaries desire that the trust assets increase without regard to what the trust is invested in, although the particulars of unitrust conversions can vary greatly from trust to trust (e.g. the percentage distributed; how often the fair market value is determined; the presence of caps and floors, etc.).

The drafting committee for the 1997 revision of the Principal and Income Act did not include a unitrust provision. In retrospect, that was an opportunity lost. By the end of 2016, 34 states (Alabama, Alaska, Arizona, California, Colorado, Delaware, Florida, Georgia, Illinois, Indiana, Iowa, Kansas, Kentucky, Maine, Maryland, Missouri, Nebraska, Nevada, New Hampshire, New York, North Carolina, Oregon, Pennsylvania, Rhode Island, South Carolina, South Dakota, Tennessee, Utah, Vermont, Virginia, Washington, West Virginia, Wisconsin, and Wyoming) had enacted statutes, some as part of their Uniform Principal and Income Acts and some separately, permitting a trustee to convert a trust to a unitrust. Some of those statutes refer to unitrusts as "total return unitrusts" (a term not used in Article 3). Those 34 states have far from uniform provisions. However, some limitations have been imposed, de facto, by the Internal Revenue Service, which since 2003 has provided that it will respect only certain unitrust provisions.

Our Article 3 attempts to provide the greatest latitude for unitrust conversion, and to deal comprehensively with the issues that have arisen under the various existing state acts. The drafting committee believes that our act will provide a popular replacement for the existing provisions in many, perhaps most, states, as well as be attractive to the approximately one-third of states that lack any such provision.

Section 104. New Section 104 provides an important clarification that the income and principal rules of the state that is the principal place of administration of the trust from time to time will be the governing law. This is an important addition to existing acts.

Retention of Existing Default Rules. The drafting committee has consulted with experts in various industries in an effort to determine what the proper default rules should be under the act for specialized allocations like oil and gas interests, timber interests, patents and other intellectual property, distributions from passthrough entities, and so forth. That consultation is ongoing, and the committee expects to discuss and incorporate the recommendations as appropriate at its Fall drafting meeting.

A Word About the Name. Each of the previous principal and income acts has been referred to as a principal and income act, with revised or a parenthetical year designation, as appropriate. The drafting committee considered at length (some might say at too long a length!) whether to continue that policy or to adopt a new name. The committee concluded that a new name was important, as was switching the order, from "principal and income" to "income and principal." The modifier fiduciary signals that the act deals with trusts, but also with decedents' estates and life estates. Income, then principal, suggests that a trustee ought to determine the appropriate amount, economically, to treat as income, leaving the remaining trust assets as principal, rather than assuming that a trust is all principal except for certain receipts designated income. This difference may be more attitudinal than substantive, but the drafting committee views the change in wording as an important element of how allocations between income and principal affect the acceptance and administration of trusts in the future.