

MAINE STATE LEGISLATURE

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120th MAINE LEGISLATURE

FIRST REGULAR SESSION-2001

Legislative Document

No. 1573

H.P. 1173

House of Representatives, March 13, 2001

An Act to Enact the Uniform Principal and Income Act of 1997.

Reference to the Committee on Judiciary suggested and ordered printed.

Millicent M. MacFarland

MILLICENT M. MacFARLAND, Clerk

Presented by Representative NORBERT of Portland.
Cosponsored by Senator RAND of Cumberland and
Representative SIMPSON of Auburn, Senator: FERGUSON of Oxford.

2 **Be it enacted by the People of the State of Maine as follows:**

4 **UNIFORM COMMENT**

6 **PREFATORY NOTE**

8 This revision of the 1931 Uniform Principal and Income Act
and the 1962 Revised Uniform Principal and Income Act has two
purposes.

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

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

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

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

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

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

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

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

48 Changes in the traditional sections are of three types: new
rules that deal with situations not covered by the prior Acts,

clarification of provisions in the 1962 Act, and changes to rules
in the prior Acts.

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

(1) The application of the probate administration rules to
revocable living trusts after the settlor's death and to other
terminating trusts. Articles 2 and 3.

(2) The payment of interest or some other amount on the
delayed payment of an outright pecuniary gift that is made
pursuant to a trust agreement instead of a will when the
agreement or state law does not provide for such a payment.
Section 201(3).

(3) The allocation of net income from partnership interests
acquired by the trustee other than from a decedent (the old Acts
deal only with partnership interests acquired from a decedent).
Section 401.

(4) An "unincorporated entity" concept has been introduced
to deal with businesses operated by a trustee, including farming
and livestock operations, and investment activities in rental
real estate, natural resources, timber, and derivatives. Section
403.

(5) The allocation of receipts from discount obligations
such as zero-coupon bonds. Section 406(b).

(6) The allocation of net income from harvesting and
selling timber between principal and income. Section 412.

(7) The allocation between principal and income of receipts
from derivatives, options, and asset-backed securities. Sections
414 and 415.

(8) Disbursements made because of environmental laws.
Section 502(a)(7).

(9) Income tax obligations resulting from the ownership of
S corporation stock and interests in partnerships. Section 505.

(10) The power to make adjustments between principal and
income to correct inequities caused by tax elections or
peculiarities in the way the fiduciary income tax rules apply.
Section 506.

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

5 (1) An income beneficiary's estate will be entitled to
6 receive only net income actually received by a trust before the
7 beneficiary's death and not items of accrued income. Section 303.

8 (2) Income from a partnership is based on actual
9 distributions from the partnership, in the same manner as
10 corporate distributions. Section 401.

11 (3) Distributions from corporations and partnerships that
12 exceed 20% of the entity's gross assets will be principal whether
13 or not intended by the entity to be a partial liquidation.
14 Section 401(d)(2).

15 (4) Deferred compensation is dealt with in greater detail
16 in a separate section. Section 409.

17 (5) The 1962 Act rule for "property subject to depletion,"
18 (patents, copyrights, royalties, and the like), which provides
19 that a trustee may allocate up to 5% of the asset's inventory
20 value to income and the balance to principal, has been replaced
21 by a rule that allocates 90% of the amounts received to principal
22 and the balance to income. Section 410.

23 (6) The percentage used to allocate amounts received from
24 oil and gas has been changed - 90% of those receipts are
25 allocated to principal and the balance to income. Section 411.

26 (7) The unproductive property rule has been eliminated for
27 trusts other than marital deduction trusts. Section 413.

28 (8) Charging depreciation against income is no longer
29 mandatory, and is left to the discretion of the trustee. Section
30 503.

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

32 The law of trust investment has been modernized. See
33 Uniform Prudent Investor Act (1994); Restatement (Third) of
34 Trusts: Prudent Investor Rule (1992) (hereinafter Restatement of
35 Trusts 3d: Prudent Investor Rule). Now it is time to update the
36 principal and income allocation rules so the two bodies of
37 doctrine can work well together. This revision deals
38 conservatively with the tension between modern investment theory
39 and traditional income allocation. The starting point is to use
40 the traditional system. If prudent investing of all the assets
41 in a trust viewed as a portfolio and traditional allocation

2 effectuate the intent of the settlor, then nothing need be done.
3 The Act, however, helps the trustee who has made a prudent,
4 modern portfolio-based investment decision that has the initial
5 effect of skewing return from all the assets under management,
6 viewed as a portfolio, as between income and principal
7 beneficiaries. The Act gives that trustee a power to reallocate
8 the portfolio return suitably. To leave a trustee constrained by
9 the traditional system would inhibit the trustee's ability to
10 fully implement modern portfolio theory.

11
12 As to modern investing see, e.g., the Preface to, terms of,
13 and Comments to the Uniform Prudent Investor Act (1994); the
14 discussion and reporter's note by Edward C. Halbach, Jr. in
15 Restatement of Trusts 3d: Prudent Investor Rule; John H.
16 Langbein, The Uniform Prudent Investor Act and the Future of
17 Trust Investing, 81 Iowa L. Rev. 641 (1996); Bevis Longstreth,
18 Modern Investment Management and the Prudent Man Rule (1986);
19 John H. Langbein & Richard A. Posner, The Revolution in Trust
20 Investment Law, 62 A.B.A.J. 887 (1976); and Jeffrey N. Gordon,
21 The Puzzling Persistence of the Constrained Prudent Man Rule, 62
22 N.Y.U. L. Rev. 52 (1987). See also R.A. Brearly, An Introduction
23 to Risk and Return from Common Stocks (2d ed. 1983); Jonathan R.
24 Macey, An Introduction to Modern Financial Theory (2d ed. 1998).
25 As to the need for principal and income reform see, e.g., Joel C.
26 Dobris, Real Return, Modern Portfolio Theory and College,
27 University and Foundation Decisions on Annual Spending From
28 Endowments: A Visit to the World of Spending Rules, 28 Real
29 Prop., Prob., & Tr. J. 49 (1993); Joel C. Dobris, The Probate
30 World at the End of the Century: Is a New Principal and Income
31 Act in Your Future?, 28 Real Prop., Prob., & Tr. J. 393 (1993);
32 and Kenneth L. Hirsch, Inflation and the Law of Trusts, 18 Real
33 Prop., Prob., & Tr. J. 601 (1983). See also, Jerold I. Horn, The
34 Prudent Investor Rule - Impact on Drafting and Administration of
35 Trusts, 20 ACTEC Notes 26 (Summer 1994).

36 **Sec. 1. 18-A MRS Art. VII, Pt. 7** is enacted to read:

37 **PART 7**

38 **UNIFORM PRINCIPAL AND INCOME ACT OF 1997**

39 **SUBPART 1**

40 **DEFINITIONS AND FIDUCIARY DUTIES**

41 **§7-701. Short title**

42 This Part may be cited as the "Uniform Principal and Income
43 Act of 1997."

§7-702. Definitions

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4 As used in this Part, unless the context otherwise indicates, the following terms have the following meanings.

6 (a) "Accounting period" means a calendar year unless
8 another 12-month period is selected by a fiduciary. The term
10 includes a portion of a calendar year or other 12-month period
that begins when an income interest begins or ends when an income
interest ends.

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

16 (c) "Fiduciary" means a personal representative or a
18 trustee. The term includes an executor, administrator, successor
20 personal representative, special administrator and a person
performing substantially the same function.

22 (d) "Income" means money or property that a fiduciary
24 receives as current return from a principal asset. The term
includes a portion of receipts from a sale, exchange or
liquidation of a principal asset, to the extent provided in
subpart 4.

26 (e) "Income beneficiary" means a person to whom net income
28 of a trust is or may be payable.

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

34 (g) "Mandatory income interest" means the right of an
36 income beneficiary to receive net income that the terms of the
trust require the fiduciary to distribute.

38 (h) "Net income" means the total receipts allocated to
40 income during an accounting period minus the disbursements made
from income during the period, plus or minus transfers under this
42 Part to or from income during the period.

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

2 Section 103(a)(2) incorporates the rule in Section 2(b) of the
3 1962 Act that a discretionary allocation made by the trustee that
4 is contrary to a rule in the Act should not give rise to an
inference of imprudence or partiality by the trustee.

6 The Act deletes the language that appears at the end of
7 1962 Act Section 2(a)(3) - "and in view of the manner in which
8 men of ordinary prudence, discretion and judgment would act in
9 the management of their affairs" - because persons of ordinary
10 prudence, discretion and judgment, acting in the management of
11 their own affairs do not normally think in terms of the interests
12 of successive beneficiaries. If there is an analogy to an
13 individual's decisionmaking process, it is probably the
14 individual's decision to spend or to save, but this is not a
15 useful guideline for trust administration. No case has been
16 found in which a court has relied on the "prudent man" rule of
the 1962 Act.

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

26 **Questions for which there is no provision.** Section
27 103(a)(4) allocates receipts and disbursements to principal when
28 there is no provision for a different allocation in the terms of
29 the trust, the will or the Act. This may occur because money is
30 received from a financial instrument not available at the present
31 time (inflation-indexed bonds might have fallen into this
32 category had they been announced after this Act was approved by
33 the Commissioners on Uniform State Laws) or because a transaction
34 is of a type or occurs in a manner not anticipated by the
35 Drafting Committee for this Act or the drafter of the trust
36 instrument.

38 Allocating to principal a disbursement for which there is no
39 provision in the Act or the terms of the trust preserves the
40 income beneficiary's level of income in the year it is allocated
41 to principal, but thereafter will reduce the amount of income
42 produced by the principal. Allocating to principal a receipt for
43 which there is no provision will increase the income received by
44 the income beneficiary in subsequent years, and will eventually,
45 upon termination of the trust, also favor the remainder
46 beneficiary. Allocating these items to principal implements the
47 rule that requires a trustee to administer the trust impartially,
48 based on what is fair and reasonable to both income and remainder
49 beneficiaries. However, if the trustee decides that an
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2 adjustment between principal and income is needed to enable the
trustee to comply with Section 103(b), after considering the
4 return from the portfolio as a whole, the trustee may make an
appropriate adjustment under Section 104(a).

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

22 The terms of a trust may provide that the trustee, or an
accountant engaged by the trustee, or a committee of persons who
24 may be family members or business associates, shall have the
power to determine what is income and what is principal. If the
26 terms of a trust provide that this Act specifically or principal
and income legislation in general does not apply to the trust but
28 fail to provide a rule to deal with a matter provided for in this
Act, the trustee has an implied grant of discretion to decide the
30 question. Section 103(b) provides that the rule of impartiality
applies in the exercise of such a discretionary power to the
32 extent that the terms of the trust do not provide that one or
more of the beneficiaries are to be favored. The fact that a
34 person is named an income beneficiary or a remainder beneficiary
is not by itself an indication of partiality for that beneficiary.
36

38 **§7-704. Trustee's power to adjust**

40 (a) A trustee may adjust between principal and income to
the extent the trustee considers necessary if the trustee invests
and manages trust assets as a prudent investor, the terms of the
trust describe the amount that may or must be distributed to a
beneficiary by referring to the trust's income and the trustee
determines, after applying the rules in section 7-703, subsection
(a), that the trustee is unable to comply with section 7-703,
subsection (b).
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48 (b) In deciding whether and to what extent to exercise the
power conferred by subsection (a), a trustee shall consider all

2 factors relevant to the trust and its beneficiaries, including
3 the following factors to the extent they are relevant:

4 (1) The nature, purpose and expected duration of the trust;

6 (2) The intent of the settlor;

8 (3) The identity and circumstances of the beneficiaries;

10 (4) The needs for liquidity, regularity of income and
11 preservation and appreciation of capital;

12 (5) The assets held in the trust; the extent to which they
13 consist of financial assets, interests in closely held
14 enterprises, tangible and intangible personal property or
15 real property; the extent to which an asset is used by a
16 beneficiary; and whether an asset was purchased by the
17 trustee or received from the settlor;

20 (6) The net amount allocated to income under the other
21 sections of this Part and the increase or decrease in the
22 value of the principal assets, which the trustee may
23 estimate as to assets for which market values are not
24 readily available;

26 (7) Whether and to what extent the terms of the trust give
27 the trustee the power to invade principal or accumulate
28 income or prohibit the trustee from invading principal or
29 accumulating income, and the extent to which the trustee has
30 exercised a power from time to time to invade principal or
31 accumulate income;

32 (8) The actual and anticipated effect of economic
33 conditions on principal and income and effects of inflation
34 and deflation; and

35 (9) The anticipated tax consequences of an adjustment.

36 (c) A trustee may not make an adjustment:

37 (1) That diminishes the income interest in a trust that
38 requires all of the income to be paid at least annually to a
39 spouse and for which an estate tax or gift tax marital
40 deduction would be allowed, in whole or in part, if the
41 trustee did not have the power to make the adjustment;

42 (2) That reduces the actuarial value of the income interest
43 in a trust to which a person transfers property with the
44 intent to qualify for a gift tax exclusion;

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2 (3) That changes the amount payable to a beneficiary as a
4 fixed annuity or a fixed fraction of the value of the trust
6 assets;

8 (4) From any amount that is permanently set aside for
10 charitable purposes under a will or the terms of a trust
12 unless both income and principal are so set aside;

14 (5) If possessing or exercising the power to make an
16 adjustment causes an individual to be treated as the owner
18 of all or part of the trust for income tax purposes and the
20 individual would not be treated as the owner if the trustee
22 did not possess the power to make an adjustment;

24 (6) If possessing or exercising the power to make an
26 adjustment causes all or part of the trust assets to be
28 included for estate tax purposes in the estate of an
30 individual who has the power to remove a trustee or appoint
32 a trustee, or both, and the assets would not be included in
34 the estate of the individual if the trustee did not possess
36 the power to make an adjustment;

38 (7) If the trustee is a beneficiary of the trust; or

40 (8) If the trustee is not a beneficiary, but the adjustment
42 would benefit the trustee directly or indirectly.

44 (d) If subsection (c), paragraph (5), (6), (7) or (8)
46 applies to a trustee and there is more than one trustee, a
48 cotrustee to whom the provision does not apply may make the
50 adjustment unless the exercise of the power by the remaining
 trustee or trustees is not permitted by the terms of the trust.

(e) A trustee may release the entire power conferred by
 subsection (a) or may release only the power to adjust from
 income to principal or the power to adjust from principal to
 income if the trustee is uncertain about whether possessing or
 exercising the power will cause a result described in subsection
 (c), paragraphs (1) to (6) or paragraph (8) or if the trustee
 determines that possessing or exercising the power will or may
 deprive the trust of a tax benefit or impose a tax burden not
 described in subsection (c). The release may be permanent or for
 a specified period, including a period measured by the life of an
 individual.

(f) Terms of a trust that limit the power of a trustee to
 make an adjustment between principal and income do not affect the
 application of this section unless it is clear from the terms of
 the trust that the terms are intended to deny the trustee the
 power of adjustment conferred by subsection (a).

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Uniform Comment

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(This is Section 104 of the Uniform Principal and Income Act (1997).)

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Purpose and Scope of Provision. The purpose of Section 104 is to enable a trustee to select investments using the standards of a prudent investor without having to realize a particular portion of the portfolio's total return in the form of traditional trust accounting income such as interest, dividends, and rents. Section 104(a) authorizes a trustee to make adjustments between principal and income if three conditions are met: (1) the trustee must be managing the trust assets under the prudent investor rule; (2) the terms of the trust must express the income beneficiary's distribution rights in terms of the right to receive "income" in the sense of traditional trust accounting income; and (3) the trustee must determine, after applying the rules in Section 103(a), that he is unable to comply with Section 103(b). In deciding whether and to what extent to exercise the power to adjust, the trustee is required to consider the factors described in Section 104(b), but the trustee may not make an adjustment in circumstances described in Section 104(c).

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Section 104 does not empower a trustee to increase or decrease the degree of beneficial enjoyment to which a beneficiary is entitled under the terms of the trust; rather, it authorizes the trustee to make adjustments between principal and income that may be necessary if the income component of a portfolio's total return is too small or too large because of investment decisions made by the trustee under the prudent investor rule. The paramount consideration in applying Section 104(a) is the requirement in Section 103(b) that "a fiduciary must administer a trust or estate impartially, based on what is fair and reasonable to all of the beneficiaries, except to the extent that the terms of the trust or the will clearly manifest an intention that the fiduciary shall or may favor one or more of the beneficiaries." The power to adjust is subject to control by the court to prevent an abuse of discretion. Restatement (Second) of Trusts § 187 (1959). See also *id.* §§ 183, 232, 233, Comment p (1959).

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Section 104 will be important for trusts that are irrevocable when a State adopts the prudent investor rule by statute or judicial approval of the rule in Restatement of Trusts 3d: Prudent Investor Rule. Wills and trust instruments executed after the rule is adopted can be drafted to describe a beneficiary's distribution rights in terms that do not depend upon the amount of trust accounting income, but to the extent

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2 that drafters of trust documents continue to describe an income
beneficiary's distribution rights by referring to trust
4 accounting income, Section 104 will be an important tool in trust
administration.

6 **Three conditions to the exercise of the power to adjust.**

8 The first of the three conditions that must be met before a
trustee can exercise the power to adjust - that the trustee
invest and manage trust assets as a prudent investor - is
10 expressed in this Act by language derived from the Uniform
Prudent Investor Act, but the condition will be met whether the
12 prudent investor rule applies because the Uniform Act or other
prudent investor legislation has been enacted, the prudent
14 investor rule has been approved by the courts, or the terms of
the trust require it. Even if a State's legislature or courts
16 have not formally adopted the rule, the Restatement establishes
the prudent investor rule as an authoritative interpretation of
18 the common law prudent man rule, referring to the prudent
investor rule as a "modest reformulation of the Harvard College
20 dictum and the basic rule of prior Restatements." Restatement of
Trusts 3d: Prudent Investor Rule, Introduction, at 5. As a
22 result, there is a basis for concluding that the first condition
is satisfied in virtually all States except those in which a
24 trustee is permitted to invest only in assets set forth in a
statutory "legal list."

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28 The second condition will be met when the terms of the trust
require all of the "income" to be distributed at regular
intervals; or when the terms of the trust require a trustee to
30 distribute all of the income, but permit the trustee to decide
how much to distribute to each member of a class of
32 beneficiaries; or when the terms of a trust provide that the
beneficiary shall receive the greater of the trust accounting
34 income and a fixed dollar amount (an annuity), or of trust
accounting income and a fractional share of the value of the
36 trust assets (a unitrust amount). If the trust authorizes the
trustee in its discretion to distribute the trust's income to the
38 beneficiary or to accumulate some or all of the income, the
condition will be met because the terms of the trust do not
40 permit the trustee to distribute more than the trust accounting
income.

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44 To meet the third condition, the trustee must first meet the
requirements of Section 103(a), i.e., she must apply the terms of
the trust, decide whether to exercise the discretionary powers
46 given to the trustee under the terms of the trust, and must apply
the provisions of the Act if the terms of the trust do not
48 contain a different provision or give the trustee discretion.
Second, the trustee must determine the extent to which the terms
50 of the trust clearly manifest an intention by the settlor that

2 the trustee may or must favor one or more of the beneficiaries.
3 To the extent that the terms of the trust do not require
4 partiality, the trustee must conclude that she is unable to
5 comply with the duty to administer the trust impartially. To the
6 extent that the terms of the trust do require or permit the
7 trustee to favor the income beneficiary or the remainder
8 beneficiary, the trustee must conclude that she is unable to
9 achieve the degree of partiality required or permitted. If the
10 trustee comes to either conclusion - that she is unable to
11 administer the trust impartially or that she is unable to achieve
12 the degree of partiality required or permitted - she may exercise
13 the power to adjust under Section 104(a).

14 **Impartiality and productivity of income.** The duty of
15 impartiality between income and remainder beneficiaries is linked
16 to the trustee's duty to make the portfolio productive of trust
17 accounting income whenever the distribution requirements are
18 expressed in terms of distributing the trust's "income." The
19 1962 Act implies that the duty to produce income applies on an
20 asset by asset basis because the right of an income beneficiary
21 to receive "delayed income" from the sale proceeds of
22 underproductive property under Section 12 of that Act arises if
23 "any part of principal ... has not produced an average net income
24 of a least 1% per year of its inventory value for more than a
25 year" Under the prudent investor rule, "[t]o whatever
26 extent a requirement of income productivity exists, ... the
27 requirement applies not investment by investment but to the
28 portfolio as a whole." Restatement of Trusts 3d: Prudent
29 Investor Rule § 227, Comment *i*, at 34. The power to adjust under
30 Section 104(a) is also to be exercised by considering net income
31 from the portfolio as a whole and not investment by investment.
32 Section 413(b) of this Act eliminates the underproductive
33 property rule in all cases other than trusts for which a marital
34 deduction is allowed; the rule applies to a marital deduction
35 trust if the trust's assets "consist substantially of property
36 that does not provide the spouse with sufficient income from or
37 use of the trust assets ..." - in other words, the section
38 applies by reference to the portfolio as a whole.

40 While the purpose of the power to adjust in Section 104(a)
41 is to eliminate the need for a trustee who operates under the
42 prudent investor rule to be concerned about the income component
43 of the portfolio's total return, the trustee must still determine
44 the extent to which a distribution must be made to an income
45 beneficiary and the adequacy of the portfolio's liquidity as a
46 whole to make that distribution.

48 For a discussion of investment considerations involving
specific investments and techniques under the prudent investor

rule, see Restatement of Trusts 3d: Prudent Investor Rule § 227,
Comments k-p.

Factors to consider in exercising the power to adjust.

Section 104(b) requires a trustee to consider factors relevant to the trust and its beneficiaries in deciding whether and to what extent the power to adjust should be exercised. Section 2(c) of the Uniform Prudent Investor Act sets forth circumstances that a trustee is to consider in investing and managing trust assets. The circumstances in Section 2(c) of the Uniform Prudent Investor Act are the source of the factors in paragraphs (3) through (6) and (8) of Section 104(b) (modified where necessary to adapt them to the purposes of this Act) so that, to the extent possible, comparable factors will apply to investment decisions and decisions involving the power to adjust. If a trustee who is operating under the prudent investor rule decides that the portfolio should be composed of financial assets whose total return will result primarily from capital appreciation rather than dividends, interest, and rents, the trustee can decide at the same time the extent to which an adjustment from principal to income may be necessary under Section 104. On the other hand, if a trustee decides that the risk and return objectives for the trust are best achieved by a portfolio whose total return includes interest and dividend income that is sufficient to provide the income beneficiary with the beneficial interest to which the beneficiary is entitled under the terms of the trust, the trustee can decide that it is unnecessary to exercise the power to adjust.

Assets received from the settlor.

Section 3 of the Uniform Prudent Investor Act provides that "[a] trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying." The special circumstances may include the wish to retain a family business, the benefit derived from deferring liquidation of the asset in order to defer payment of income taxes, or the anticipated capital appreciation from retaining an asset such as undeveloped real estate for a long period. To the extent the trustee retains assets received from the settlor because of special circumstances that overcome the duty to diversify, the trustee may take these circumstances into account in determining whether and to what extent the power to adjust should be exercised to change the results produced by other provisions of this Act that apply to the retained assets. See Section 104(b)(5); Uniform Prudent Investor Act § 3, Comment, 7B U.L.A. 18, at 2526 (Supp. 1997); Restatement of Trusts 3d: Prudent Investor Rule § 229 and Comments a-e.

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

10 Under subsection (c)(1), a trustee cannot make an adjustment
that diminishes the income interest in a trust that requires all
12 of the income to be paid at least annually to a spouse and for
which an estate tax or gift tax marital deduction is allowed; but
14 this subsection does not prevent the trustee from making an
adjustment that increases the amount of income paid from a
16 marital deduction trust to the spouse. Subsection (c)(1) applies
to a trust that qualifies for the marital deduction because the
18 spouse has a general power of appointment over the trust, but it
applies to a qualified terminable interest property (QTIP) trust
20 only if and to the extent that the fiduciary makes the election
required to obtain the tax deduction. Subsection (c)(1) does not
22 apply to a so-called "estate" trust. This type of trust
qualifies for the marital deduction because the terms of the
24 trust require the principal and undistributed income to be paid
to the surviving spouse's estate when the spouse dies; it is not
26 necessary for the terms of an estate trust to require the income
to be distributed annually. Reg. § 20.2056(c)2(b)(1)(iii).

28 Subsection (c)(3) applies to annuity trusts and unitrusts
30 with no charitable beneficiaries as well as to trusts with
charitable income or remainder beneficiaries; its purpose is to
32 make it clear that a beneficiary's right to receive a fixed
annuity or a fixed fraction of the value of a trust's assets is
34 not subject to adjustment under Section 104(a). Subsection
(c)(3) does not apply to any additional amount to which the
36 beneficiary may be entitled that is expressed in terms of a right
to receive income from the trust. For example, if a beneficiary
38 is to receive a fixed annuity or the trust's income, whichever is
greater, subsection (c)(3) does not prevent a trustee from making
40 an adjustment under Section 104(a) in determining the amount of
the trust's income.

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

48 **Release of the power to adjust.** Section 104(e) permits a
50 trustee to release all or part of the power to adjust in

2 circumstances in which the possession or exercise of the power
might deprive the trust of a tax benefit or impose a tax burden.
4 For example, if possessing the power would diminish the actuarial
value of the income interest in a trust for which the income
6 beneficiary's estate may be eligible to claim a credit for
property previously taxed if the beneficiary dies within ten
8 years after the death of the person creating the trust, the
trustee is permitted under subsection (e) to release just the
power to adjust from income to principal.

10
12 **Trust terms that limit a power to adjust.** Section 104(f)
applies to trust provisions that limit a trustee's power to
14 adjust. Since the power is intended to enable trustees to employ
the prudent investor rule without being constrained by
16 traditional principal and income rules, an instrument executed
before the adoption of this Act whose terms describe the amount
that may or must be distributed to a beneficiary by referring to
18 the trust's income or that prohibit the invasion of principal or
that prohibit equitable adjustments in general should not be
20 construed as forbidding the use of the power to adjust under
Section 104(a) if the need for adjustment arises because the
22 trustee is operating under the prudent investor rule.
Instruments containing such provisions that are executed after
24 the adoption of this Act should specifically refer to the power
to adjust if the settlor intends to forbid its use. See
26 generally, Joel C. Dobris, Limits on the Doctrine of Equitable
Adjustment in Sophisticated Postmortem Tax Planning, 66 Iowa L.
28 Rev. 273 (1981).

30 **Examples.** The following examples illustrate the application
of Section 104:

32
34 **Example (1)** - T is the successor trustee of a trust that
provides income to A for life, remainder to B. T has received
36 from the prior trustee a portfolio of financial assets invested
20% in stocks and 80% in bonds. Following the prudent investor
38 rule, T determines that a strategy of investing the portfolio 50%
in stocks and 50% in bonds has risk and return objectives that
40 are reasonably suited to the trust, but T also determines that
adopting this approach will cause the trust to receive a smaller
amount of dividend and interest income. After considering the
42 factors in Section 104(b), T may transfer cash from principal to
income to the extent T considers it necessary to increase the
44 amount distributed to the income beneficiary.

46 **Example (2)** - T is the trustee of a trust that requires the
income to be paid to the settlor's son C for life, remainder to
48 C's daughter D. In a period of very high inflation, T purchases
bonds that pay double-digit interest and determines that a
50 portion of the interest, which is allocated to income under

2 Section 406 of this Act, is a return of capital. In
3 consideration of the loss of value of principal due to inflation
4 and other factors that T considers relevant, T may transfer part
5 of the interest to principal.

6 **Example (3)** - T is the trustee of a trust that requires the
7 income to be paid to the settlor's sister E for life, remainder
8 to charity F. E is a retired schoolteacher who is single and has
9 no children. E's income from her social security, pension, and
10 savings exceeds the amount required to provide for her accustomed
11 standard of living. The terms of the trust permit T to invade
12 principal to provide for E's health and to support her in her
13 accustomed manner of living, but do not otherwise indicate that T
14 should favor E or F. Applying the prudent investor rule, T
15 determines that the trust assets should be invested entirely in
16 growth stocks that produce very little dividend income. Even
17 though it is not necessary to invade principal to maintain E's
18 accustomed standard of living, she is entitled to receive from
19 the trust the degree of beneficial enjoyment normally accorded a
20 person who is the sole income beneficiary of a trust, and T may
21 transfer cash from principal to income to provide her with that
22 degree of enjoyment.

24 **Example (4)** - T is the trustee of a trust that is governed
25 by the law of State X. The trust became irrevocable before State
26 X adopted the prudent investor rule. The terms of the trust
27 require all of the income to be paid to G for life, remainder to
28 H, and also give T the power to invade principal for the benefit
29 of G for "dire emergencies only." The terms of the trust limit
30 the aggregate amount that T can distribute to G from principal
31 during G's life to 6% of the trust's value at its inception. The
32 trust's portfolio is invested initially 50% in stocks and 50% in
33 bonds, but after State X adopts the prudent investor rule T
34 determines that, to achieve suitable risk and return objectives
35 for the trust, the assets should be invested 90% in stocks and
36 10% in bonds. This change increases the total return from the
37 portfolio and decreases the dividend and interest income.
38 Thereafter, even though G does not experience a dire emergency, T
39 may exercise the power to adjust under Section 104(a) to the
40 extent that T determines that the adjustment is from only the
41 capital appreciation resulting from the change in the portfolio's
42 asset allocation. If T is unable to determine the extent to
43 which capital appreciation resulted from the change in asset
44 allocation or is unable to maintain adequate records to determine
45 the extent to which principal distributions to G for dire
46 emergencies do not exceed the 6% limitation, T may not exercise
47 the power to adjust. See Joel C. Dobris, Limits on the Doctrine
48 of Equitable Adjustment in Sophisticated Postmortem Tax Planning,
49 66 Iowa L. Rev. 273 (1981).

50

§7-721. Determination and distribution of net income

2 After a decedent dies, in the case of an estate, or after an
4 income interest in a trust ends, the following rules apply.

6 (a) A fiduciary of an estate or of a terminating income
8 interest shall determine the amount of net income and net
10 principal receipts received from property specifically given to a
12 beneficiary under the rules in subparts 3 to 5 that apply to
trustees and the rules in subsection (e). The fiduciary shall
distribute the net income and net principal receipts to the
beneficiary who is to receive the specific property.

14 (b) A fiduciary shall determine the remaining net income of
16 a decedent's estate or a terminating income interest under the
rules in subparts 3 to 5 that apply to trustees and by:

18 (1) Including in net income all income from property used
20 to discharge liabilities;

22 (2) Paying from income or principal, in the fiduciary's
24 discretion, fees of attorneys, accountants and fiduciaries;
26 court costs and other expenses of administration; and
28 interest on death taxes; but the fiduciary may pay those
30 expenses from income of property passing to a trust for
which the fiduciary claims an estate tax marital or
charitable deduction only to the extent that the payment of
those expenses from income will not cause the reduction or
loss of the deduction; and

32 (3) Paying from principal all other disbursements made or
34 incurred in connection with the settlement of a decedent's
36 estate or the winding up of a terminating income interest,
38 including debts, funeral expenses, disposition of remains,
family allowances and death taxes and related penalties that
are apportioned to the estate or terminating income interest
by the will, the terms of the trust or applicable law.

40 (c) A fiduciary shall distribute to a beneficiary who
42 receives a pecuniary amount outright the interest or any other
44 amount provided by the will, the terms of the trust or applicable
46 law from net income determined under subsection (b) or from
48 principal to the extent that net income is insufficient. If a
beneficiary is to receive a pecuniary amount outright from a
trust after an income interest ends and no interest or other
amount is provided for by the terms of the trust or applicable
law, the fiduciary shall distribute the interest or other amount
to which the beneficiary would be entitled under applicable law
if the pecuniary amount were required to be paid under a will.

2 continue in trust for another income beneficiary. While it is
3 common to think and speak of this (and even to characterize it in
4 a trust instrument) as a "new" trust, it is a continuation of the
5 original trust for a remainder beneficiary who has an income
6 interest in the trust assets instead of the right to receive them
7 outright. For purposes of this Act, this is a successive income
8 interest in the same trust. The fact that a trust may or may not
9 end when an income interest ends is not significant for purposes
10 of this Act.

11
12 If the assets that are subject to a terminating income
13 interest pass to another trust because the income beneficiary
14 exercises a general power of appointment over the trust assets,
15 the recipient trust would be a new trust; and if they pass to
16 another trust because the beneficiary exercises a nongeneral
17 power of appointment over the trust assets, the recipient trust
18 might be a new trust in some States (see 5A Austin W. Scott &
19 William F. Fratcher, *The Law of Trusts* § 640, at 483 (4th ed.
20 1989)); but for purposes of this Act a new trust created in these
21 circumstances is also a successive income interest.

22 **Gift of a pecuniary amount.** Section 201(3) and (4) provide
23 different rules for an outright gift of a pecuniary amount and a
24 gift in trust of a pecuniary amount; this is the same approach
25 used in Section 5(b)(2) of the 1962 Act.

26
27 **Interest on pecuniary amounts.** Section 201(3) provides that
28 the beneficiary of an outright pecuniary amount is to receive the
29 interest or other amount provided by applicable law if there is
30 no provision in the will or the terms of the trust. Many States
31 have no applicable law that provides for interest or some other
32 amount to be paid on an outright pecuniary gift under an inter
33 vivos trust; this section provides that in such a case the
34 interest or other amount to be paid shall be the same as the
35 interest or other amount required to be paid on testamentary
36 pecuniary gifts. This provision is intended to accord gifts
37 under inter vivos instruments the same treatment as testamentary
38 gifts. The various state authorities that provide for the amount
39 that a beneficiary of an outright pecuniary amount is entitled to
40 receive are collected in Richard B. Covey, *Marital Deduction and*
41 *Credit Shelter Dispositions and the Use of Formula Provisions*,
42 *App. B* (4th ed. 1997).

43
44 **Administration expenses and interest on death taxes.** Under
45 Section 201(2)(B) a fiduciary may pay administration expenses and
46 interest on death taxes from either income or principal. An
47 advantage of permitting the fiduciary to choose the source of the
48 payment is that, if the fiduciary's decision is consistent with
49 the decision to deduct these expenses for income tax purposes or
50 estate tax purposes, it eliminates the need to adjust between

2 principal and income that may arise when, for example, an expense
3 that is paid from principal is deducted for income tax purposes
4 or an expense that is paid from income is deducted for estate tax
5 purposes.

6 The United States Supreme Court has considered the question
7 of whether an estate tax marital deduction or charitable
8 deduction should be reduced when administration expenses are paid
9 from income produced by property passing in trust for a surviving
10 spouse or for charity and deducted for income tax purposes. The
11 Court rejected the IRS position that administration expenses
12 properly paid from income under the terms of the trust or state
13 law must reduce the amount of a marital or charitable transfer,
14 and held that the value of the transferred property is not
15 reduced for estate tax purposes unless the administration
16 expenses are material in light of the income the trust corpus
17 could have been expected to generate. Commissioner v. Estate of
18 Otis C. Hubert, 117 S.Ct. 1124 (1997). The provision in Section
19 201(2)(B) permits a fiduciary to pay and deduct administration
20 expenses from income only to the extent that it will not cause
21 the reduction or loss of an estate tax marital or charitable
22 contributions deduction, which means that the limit on the amount
23 payable from income will be established eventually by Treasury
24 Regulations.

25 **Interest on estate taxes.** The IRS agrees that interest on
26 estate and inheritance taxes may be deducted for income tax
27 purposes without having to reduce the estate tax deduction for
28 amounts passing to a charity or surviving spouse, whether the
29 interest is paid from principal or income. Rev. Rul. 9348, 932
30 C.B. 270. For estates of persons who died before 1998, a
31 fiduciary may not want to deduct for income tax purposes interest
32 on estate tax that is deferred under Section 6166 or 6163 because
33 deducting that interest for estate tax purposes may produce more
34 beneficial results, especially if the estate has little or no
35 income or the income tax bracket is significantly lower than the
36 estate tax bracket. For estates of persons who die after 1997,
37 no estate tax or income tax deduction will be allowed for
38 interest paid on estate tax that is deferred under Section 6166.
39 However, interest on estate tax deferred under Section 6163 will
40 continue to be deductible for both purposes, and interest on
41 estate tax deficiencies will continue to be deductible for estate
42 tax purposes if an election under Section 6166 is not in effect.

43 Under the 1962 Act, Section 13(c)(5) charges interest on
44 estate and inheritance taxes to principal. The 1931 Act has no
45 provision. Section 501(3) of this Act provides that, except to
46 the extent provided in Section 201(2)(B) or (C), all interest
47 must be paid from income.
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§7-722. Distribution to residuary and remainder beneficiaries

2
3 (a) Each beneficiary described in section 7-721, subsection
4 (d) is entitled to receive a portion of the net income equal to
5 the beneficiary's fractional interest in undistributed principal
6 assets, using values as of the distribution date. If a fiduciary
7 makes more than one distribution of assets to beneficiaries to
8 whom this section applies, each beneficiary, including one who
9 does not receive part of the distribution, is entitled, as of
10 each distribution date, to the net income the fiduciary has
11 received after the date of death or terminating event or earlier
12 distribution date but has not distributed as of the current
13 distribution date.

14
15 (b) In determining a beneficiary's share of net income, the
16 following rules apply.

17 (1) The beneficiary is entitled to receive a portion of the
18 net income equal to the beneficiary's fractional interest in
19 the undistributed principal assets immediately before the
20 distribution date, including assets that later may be sold
21 to meet principal obligations.

22
23 (2) The beneficiary's fractional interest in the
24 undistributed principal assets must be calculated without
25 regard to property specifically given to a beneficiary and
26 property required to pay pecuniary amounts not in trust.

27
28 (3) The beneficiary's fractional interest in the
29 undistributed principal assets must be calculated on the
30 basis of the aggregate value of those assets as of the
31 distribution date without reducing the value by any unpaid
32 principal obligation.

33
34 (4) The distribution date for purposes of this section may
35 be the date as of which the fiduciary calculates the value
36 of the assets if that date is reasonably near the date on
37 which assets are actually distributed.

38
39 (c) If a fiduciary does not distribute all of the collected
40 but undistributed net income to each person as of a distribution
41 date, the fiduciary shall maintain appropriate records showing
42 the interest of each beneficiary in that net income.

43
44 (d) A fiduciary may apply the rules in this section, to the
45 extent that the fiduciary considers it appropriate, to net gain
46 or loss realized after the date of death or terminating event or
47 earlier distribution date from the disposition of a principal
48 asset if this section applies to the income from the asset.

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Uniform Comment

(This is Section 202 of the Uniform Principal and Income Act (1997).)

Relationship to prior Acts. Section 202 retains the concept in Section 5(b)(2) of the 1962 Act that the residuary legatees of estates are to receive net income earned during the period of administration on the basis of their proportionate interests in the undistributed assets when distributions are made. It changes the basis for determining their proportionate interests by using asset values as of a date reasonably near the time of distribution instead of inventory values; it extends the application of these rules to distributions from terminating trusts; and it extends these rules to gain or loss realized from the disposition of assets during administration, an omission in the 1962 Act that has been noted by several commentators. See, e.g., Richard B. Covey, Marital Deduction and Credit Shelter Dispositions and the Use of Formula Provisions 91 (4th ed. 1998); Thomas H. Cantrill, Fractional or Percentage Residuary Bequests: Allocation of Postmortem Income, Gain and Unrealized Appreciation, 10 Prob. Notes 322, 327 (1985).

SUBPART 3

**APPORTIONMENT AT BEGINNING
AND END OF INCOME INTEREST**

§7-731. When right to income begins and ends

(a) An income beneficiary is entitled to net income from the date on which the income interest begins. An income interest begins on the date specified in the terms of the trust or, if no date is specified, on the date an asset becomes subject to a trust or successive income interest.

(b) An asset becomes subject to a trust:

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

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

2 an income interest begins must be allocated to principal and the
3 balance must be allocated to income.

4 (c) An item of income or an obligation is due on the date
5 the payor is required to make a payment. If a payment date is
6 not stated, there is no due date for the purposes of this Part.
7 Distributions to shareholders or other owners from an entity to
8 which section 7-741 applies are deemed to be due on the date
9 fixed by the entity for determining who is entitled to receive
10 the distribution or, if no date is fixed, on the declaration date
11 for the distribution. A due date is periodic for receipts or
12 disbursements that must be paid at regular intervals under a
13 lease or an obligation to pay interest or if an entity
14 customarily makes distributions at regular intervals.

16
17 **Uniform Comment**

18
19 (This is Section 302 of the Uniform Principal and Income Act
20 (1997).)

22 **Prior Acts.** Professor Bogert stated that "Section 4 of the
23 [1962] Act makes a change with respect to the apportionment of
24 the income of trust property not due until after the trust began
25 but which accrued in part before the commencement of the trust.
26 It treats such income as to be credited entirely to the income
27 account in the case of a living trust, but to be apportioned
28 between capital and income in the case of a testamentary trust.
29 The [1931] Act apportions such income in the case of both types
30 of trusts, except in the case of corporate dividends." George G.
31 Bogert, *The Revised Uniform Principal and Income Act*, 38 Notre
32 Dame Law. 50, 52 (1962). The 1962 Act also provides that an
33 asset passing to an inter vivos trust by a bequest in the
34 settlor's will is governed by the rule that applies to a
35 testamentary trust, so that different rules apply to assets
36 passing to an inter vivos trust depending upon whether they were
37 transferred to the trust during the settlor's life or by his will.

38
39 Having several different rules that apply to similar
40 transactions is confusing. In order to simplify administration,
41 Section 302 applies the same rule to inter vivos trusts
42 (revocable and irrevocable), testamentary trusts, and assets that
43 become subject to an inter vivos trust by a testamentary bequest.

44
45 **Periodic payments.** Under Section 302, a periodic payment is
46 principal if it is due but unpaid before a decedent dies or
47 before an asset becomes subject to a trust, but the next payment
48 is allocated entirely to income and is not apportioned. Thus,
49 periodic receipts such as rents, dividends, interest, and
50 annuities, and disbursements such as the interest portion of a

2 mortgage payment, are not apportioned. This is the original
3 common law rule. Edwin A. Howes, Jr., The American Law Relating
4 to Income and Principal 70 (1905). In trusts in which a
5 surviving spouse is dependent upon a regular flow of cash from
6 the decedent's securities portfolio, this rule will help to
7 maintain payments to the spouse at the same level as before the
8 settlor's death. Under the 1962 Act, the pre-death portion of
9 the first periodic payment due after death is apportioned to
10 principal in the case of a testamentary trust or securities
bequeathed by will to an inter vivos trust.

12 **Nonperiodic payments.** Under the second sentence of Section
13 302(b), interest on an obligation that does not provide a due
14 date for the interest payment, such as interest on an income tax
15 refund, would be apportioned to principal to the extent it
16 accrues before a person dies or an income interest begins unless
17 the obligation is specifically given to a devisee or remainder
18 beneficiary, in which case all of the accrued interest passes
19 under Section 201(1) to the person who receives the obligation.
20 The same rule applies to interest on an obligation that has a due
21 date but does not provide for periodic payments. If there is no
22 stated interest on the obligation, such as a zero coupon bond,
23 and the proceeds from the obligation are received more than one
24 year after it is purchased or acquired by the trustee, the entire
25 amount received is principal under Section 406.

26
27
28 **§7-733. Apportionment when income interest ends**

30 (a) In this section, "undistributed income" means net
31 income received before the date on which an income interest
32 ends. The term does not include an item of income or expense
33 that is due or accrued or net income that has been added or is
34 required to be added to principal under the terms of the trust.

36 (b) When a mandatory income interest ends, the trustee
37 shall pay to a mandatory income beneficiary who survives that
38 date, or the estate of a deceased mandatory income beneficiary
39 whose death causes the interest to end, the beneficiary's share
40 of the undistributed income that is not disposed of under the
41 terms of the trust unless the beneficiary has an unqualified
42 power to revoke more than 5% of the trust immediately before the
43 income interest ends. In the latter case, the undistributed
44 income from the portion of the trust that may be revoked must be
45 added to principal.

46
47 (c) When a trustee's obligation to pay a fixed annuity or a
48 fixed fraction of the value of the trust's assets ends, the
49 trustee shall prorate the final payment to the extent required by
50 applicable law to accomplish a purpose of the trust or its

2 settlor relating to income, gift, estate or other tax
3 requirements.

4
5 **Uniform Comment**

6
7 (This is Section 303 of the Uniform Principal and Income Act
8 (1997).)

10 **Prior Acts.** Both the 1931 Act (Section 4) and the 1962 Act
11 (Section 4(d)) provide that a deceased income beneficiary's
12 estate is entitled to the undistributed income. The Drafting
13 Committee concluded that this is probably not what most settlors
14 would want, and that, with respect to undistributed income, most
15 settlors would favor the income beneficiary first, the remainder
16 beneficiaries second, and the income beneficiary's heirs last, if
17 at all. However, it decided not to eliminate this provision to
18 avoid causing disputes about whether the trustee should have
19 distributed collected cash before the income beneficiary died.

20
21 **Accrued periodic payments.** Under the prior Acts, an income
22 beneficiary or his estate is entitled to receive a portion of any
23 payments, other than dividends, that are due or that have accrued
24 when the income interest terminates. The last sentence of
25 subsection (a) changes that rule by providing that such items are
26 not included in undistributed income. The items affected include
27 periodic payments of interest, rent, and dividends, as well as
28 items of income that accrue over a longer period of time; the
29 rule also applies to expenses that are due or accrued.

30
31 **Example - accrued periodic payments.** The rules in Section
32 302 and Section 303 work in the following manner: Assume that a
33 periodic payment of rent that is due on July 20 has not been paid
34 when an income interest ends on July 30; the successive income
35 interest begins on July 31, and the rent payment that was due on
36 July 20 is paid on August 3. Under Section 302(a), the July 20
37 payment is added to the principal of the successive income
38 interest when received. Under Section 302(b), the entire
39 periodic payment of rent that is due on August 20 is income when
40 received by the successive income interest. Under Section 303,
41 neither the income beneficiary of the terminated income interest
42 nor the beneficiary's estate is entitled to any part of either
43 the July 20 or the August 20 payments because neither one was
44 received before the income interest ended on July 30. The same
45 principles apply to expenses of the trust.

46
47 **Beneficiary with an unqualified power to revoke.** The
48 requirement in subsection (b) to pay undistributed income to a
49 mandatory income beneficiary or her estate does not apply to the
50 extent the beneficiary has an unqualified power to revoke more

2 than five percent of the trust immediately before the income
interest ends. Without this exception, subsection (b) would
4 apply to a revocable living trust whose settlor is the mandatory
income beneficiary during her lifetime, even if her will provides
6 that all of the assets in the probate estate are to be
distributed to the trust.

8 If a trust permits the beneficiary to withdraw all or a part
of the trust principal after attaining a specified age and the
10 beneficiary attains that age but fails to withdraw all of the
principal that she is permitted to withdraw, a trustee is not
12 required to pay her or her estate the undistributed income
attributable to the portion of the principal that she left in the
14 trust. The assumption underlying this rule is that the
beneficiary has either provided for the disposition of the trust
16 assets (including the undistributed income) by exercising a power
of appointment that she has been given or has not withdrawn the
18 assets because she is willing to have the principal and
undistributed income be distributed under the terms of the
20 trust. If the beneficiary has the power to withdraw 25% of the
trust principal, the trustee must pay to her or her estate the
22 undistributed income from the 75% that she cannot withdraw.

24 SUBPART 4

26 ALLOCATION OF RECEIPTS DURING
28 ADMINISTRATION OF TRUST

30 §7-741. Character of receipts

32 (a) In this section, "entity" means a corporation,
partnership, limited liability company, regulated investment
company, real estate investment trust, common trust fund or any
34 other organization in which a trustee has an interest other than
a trust or estate to which section 7-742 applies, a business or
36 activity to which section 7-743 applies or an asset-backed
security to which section 7-755 applies.

38
40 (b) Except as otherwise provided in this section, a trustee
shall allocate to income money received from an entity.

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

44 (1) Property other than money;

46
48 (2) Money received in one distribution or a series of
related distributions in exchange for part or all of a
50 trust's interest in the entity;

2 **Capital gain dividends.** Under the Internal Revenue Code and
the Income Tax Regulations, a "capital gain dividend" from a
4 mutual fund or real estate investment trust is the excess of the
fund's or trust's net long-term capital gain over its net
6 short-term capital loss. As a result, a capital gain dividend
does not include any net short-term capital gain, and cash
8 received by a trust because of a net short-term capital gain is
income under this Act.

10 **Reinvested dividends.** If a trustee elects (or continues an
election made by its predecessor) to reinvest dividends in shares
12 of stock of a distributing corporation or fund, whether evidenced
by new certificates or entries on the books of the distributing
14 entity, the new shares would be principal. Making or continuing
such an election would be equivalent to deciding under Section
16 104 to transfer income to principal in order to comply with
Section 103(b). However, if the trustee makes or continues the
18 election for a reason other than to comply with Section 103(b),
e.g., to make an investment without incurring brokerage
20 commissions, the trustee should transfer cash from principal to
income in an amount equal to the reinvested dividends.

22 **Distribution of property.** The 1962 Act describes a number
24 of types of property that would be principal if distributed by a
corporation. This becomes unwieldy in a section that applies to
26 both corporations and all other entities. By stating that
principal includes the distribution of any property other than
28 money, Section 401 embraces all of the items enumerated in
Section 6 of the 1962 Act as well as any other form of
30 nonmonetary distribution not specifically mentioned in that Act.

32 **Partial liquidations.** Under subsection (d)(1), any
distribution designated by the entity as a partial liquidating
34 distribution is principal regardless of the percentage of total
assets that it represents. If a distribution exceeds 20% of the
36 entity's gross assets, the entire distribution is a partial
liquidation under subsection (d)(2) whether or not the entity
38 describes it as a partial liquidation. In determining whether a
distribution is greater than 20% of the gross assets, the portion
40 of the distribution that does not exceed the amount of income tax
that the trustee or a beneficiary must pay on the entity's
42 taxable income is ignored.

44 **Other large distributions.** A cash distribution may be quite
large (for example, more than 10% but not more than 20% of the
46 entity's gross assets) and have characteristics that suggest it
should be treated as principal rather than income. For example,
48 an entity may have received cash from a source other than the
conduct of its normal business operations because it sold an
50 investment asset; or because it sold a business asset other than

2 one held for sale to customers in the normal course of its
3 business and did not replace it; or it borrowed a large sum of
4 money and secured the repayment of the loan with a substantial
5 asset; or a principal source of its cash was from assets such as
6 mineral interests, 90% of which would have been allocated to
7 principal if the trust had owned the assets directly. In such a
8 case the trustee, after considering the total return from the
9 portfolio as a whole and the income component of that return, may
10 decide to exercise the power under Section 104(a) to make an
11 adjustment between income and principal, subject to the
12 limitations in Section 104(c).

14 **§7-742. Distribution from trust or estate**

16 A trustee shall allocate to income an amount received as a
17 distribution of income from a trust or an estate in which the
18 trust has an interest other than a purchased interest, and shall
19 allocate to principal an amount received as a distribution of
20 principal from such a trust or estate. If a trustee purchases an
21 interest in a trust that is an investment entity, or a decedent
22 or donor transfers an interest in such a trust to a trustee,
23 section 7-741 or 7-755 applies to a receipt from the trust.

26 **Uniform Comment**

28 (This is Section 402 of the Uniform Principal and Income Act
29 (1997).)

30 **Terms of the distributing trust or estate.** Under Section
31 103(a), a trustee is to allocate receipts in accordance with the
32 terms of the recipient trust or, if there is no provision, in
33 accordance with this Act. However, in determining whether a
34 distribution from another trust or an estate is income or
35 principal, the trustee should also determine what the terms of
36 the distributing trust or estate say about the distribution - for
37 example, whether they direct that the distribution, even though
38 made from the income of the distributing trust or estate, is to
39 be added to principal of the recipient trust. Such a provision
40 should override the terms of this Act, but if the terms of the
41 recipient trust contain a provision requiring such a distribution
42 to be allocated to income, the trustee may have to obtain a
43 judicial resolution of the conflict between the terms of the two
44 documents.

46 **Investment trusts.** An investment entity to which the second
47 sentence of this section applies includes a mutual fund, a common
48 trust fund, a business trust or other entity organized as a trust
49 for the purpose of receiving capital contributed by investors,
50

investing that capital, and managing investment assets, including
asset-backed security arrangements to which Section 415 applies.
See John H. Langbein, *The Secret Life of the Trust: The Trust as
an Instrument of Commerce*, 107 *Yale L.J.* 165 (1997).

§7-743. Business and other activities conducted by trustee

(a) If a trustee who conducts a business or other activity determines that it is in the best interest of all the beneficiaries to account separately for the business or activity instead of accounting for it as part of the trust's general accounting records, the trustee may maintain separate accounting records for its transactions, whether or not its assets are segregated from other trust assets.

(b) A trustee who accounts separately for a business or other activity may determine the extent to which its net cash receipts must be retained for working capital, the acquisition or replacement of fixed assets, and other reasonably foreseeable needs of the business or activity, and the extent to which the remaining net cash receipts are accounted for as principal or income in the trust's general accounting records. If a trustee sells assets of the business or other activity, other than in the ordinary course of the business or activity, the trustee shall account for the net amount received as principal in the trust's general accounting records to the extent the trustee determines that the amount received is no longer required in the conduct of the business.

(c) Activities for which a trustee may maintain separate accounting records include:

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

(2) Farming;

(3) Raising and selling livestock and other animals;

(4) Management of rental properties;

(5) Extraction of minerals and other natural resources;

(6) Timber operations; and

(7) Activities to which section 7-754 applies.

Uniform Comment

(This is Section 403 of the Uniform Principal and Income Act
(1997).)

Purpose and scope. The provisions in Section 403 are intended to give greater flexibility to a trustee who operates a business or other activity in proprietorship form rather than in a wholly-owned corporation (or, where permitted by state law, a single-member limited liability company), and to facilitate the trustee's ability to decide the extent to which the net receipts from the activity should be allocated to income, just as the board of directors of a corporation owned entirely by the trust would decide the amount of the annual dividend to be paid to the trust. It permits a trustee to account for farming or livestock operations, rental properties, oil and gas properties, timber operations, and activities in derivatives and options as though they were held by a separate entity. It is not intended, however, to permit a trustee to account separately for a traditional securities portfolio to avoid the provisions of this Act that apply to such securities.

Section 403 permits the trustee to account separately for each business or activity for which the trustee determines separate accounting is appropriate. A trustee with a computerized accounting system may account for these activities in a "subtrust"; an individual trustee may continue to use the business and record-keeping methods employed by the decedent or transferor who may have conducted the business under an assumed name. The intent of this section is to give the trustee broad authority to select business record-keeping methods that best suit the activity in which the trustee is engaged.

If a fiduciary liquidates a sole proprietorship or other activity to which Section 403 applies, the proceeds would be added to principal, even though derived from the liquidation of accounts receivable, because the proceeds would no longer be needed in the conduct of the business. If the liquidation occurs during probate or during an income interest's winding up period, none of the proceeds would be income for purposes of Section 201.

Separate accounts. A trustee may or may not maintain separate bank accounts for business activities that are accounted for under Section 403. A professional trustee may decide not to maintain separate bank accounts, but an individual trustee, especially one who has continued a decedent's business practices, may continue the same banking arrangements that were used during the decedent's lifetime. In either case, the trustee is authorized to decide to what extent cash is to be retained as part of the business assets and to what extent it is to be transferred to the trust's general accounts, either as income or principal.

2 **§7-744. Principal receipts**

4 A trustee shall allocate to principal:

6 (a) To the extent not allocated to income under this Part,
8 assets received from a transferor during the transferor's
10 lifetime, a decedent's estate, a trust with a terminating income
 interest or a payor under a contract naming the trust or its
 trustee as beneficiary;

12 (b) Money or other property received from the sale,
14 exchange, liquidation or change in form of a principal asset,
 including realized profit, subject to this subpart;

16 (c) Amounts recovered from 3rd parties to reimburse the
18 trust because of disbursements described in section 7-762,
 subsection (a), paragraph (7) or for other reasons to the extent
 not based on the loss of income;

20 (d) Proceeds of property taken by eminent domain, but a
22 separate award made for the loss of income with respect to an
24 accounting period during which a current income beneficiary had a
 mandatory income interest is income;

26 (e) Net income received in an accounting period during
28 which there is no beneficiary to whom a trustee may or must
 distribute income; and

30 (f) Other receipts as provided in sections 7-748 to 7-755.

32

Uniform Comment

34

 (This is Section 404 of the Uniform Principal and Income Act
36 (1997).)

38 **Eminent domain awards.** Even though the award in an eminent
40 domain proceeding may include an amount for the loss of future
 rent on a lease, if that amount is not separately stated the
42 entire award is principal. The rule is the same in the 1931 and
 1962 Acts.

44

46 **§7-745. Rental property**

48

To the extent that a trustee accounts for receipts from
48 rental property pursuant to this section, the trustee shall
50 allocate to income an amount received as rent of real or personal
 property, including an amount received for cancellation or

2 renewal of a lease. An amount received as a refundable deposit,
4 including a security deposit or a deposit that is to be applied
6 as rent for future periods, must be added to principal and held
8 subject to the terms of the lease and is not available for
10 distribution to a beneficiary until the trustee's contractual
12 obligations have been satisfied with respect to that amount.

8
10 **Uniform Comment**

12 (This is Section 405 of the Uniform Principal and Income Act
14 (1997).)

16 **Application of Section 403.** This section applies to the
18 extent that the trustee does not account separately under Section
20 403 for the management of rental properties owned by the trust.

22 **Receipts that are capital in nature.** A portion of the
24 payment under a lease may be a reimbursement of principal
26 expenditures for improvements to the leased property that is
28 characterized as rent for purposes of invoking contractual or
30 statutory remedies for nonpayment. If the trustee is accounting
32 for rental income under Section 405, a transfer from income to
34 reimburse principal may be appropriate under Section 504 to the
36 extent that some of the "rent" is really a reimbursement for
38 improvements. This set of facts could also be a relevant factor
40 for a trustee to consider under Section 104(b) in deciding
42 whether and to what extent to make an adjustment between
44 principal and income under Section 104(a) after considering the
46 return from the portfolio as a whole.

32 **§7-746. Obligation to pay money**

34 (a) An amount received as interest, whether determined at a
36 fixed, variable or floating rate, on an obligation to pay money
38 to the trustee, including an amount received as consideration for
40 prepaying principal, must be allocated to income without any
42 provision for amortization of premium.

44 (b) A trustee shall allocate to principal an amount
46 received from the sale, redemption or other disposition of an
48 obligation to pay money to the trustee more than one year after
it is purchased or acquired by the trustee, including an
obligation whose purchase price or value when it is acquired is
less than its value at maturity. If the obligation matures
within one year after it is purchased or acquired by the trustee,
an amount received in excess of its purchase price or its value
when acquired by the trust must be allocated to income.

2 (c) This section does not apply to an obligation to which
3 section 7-749, 7-750, 7-751, 7-752, 7-754 or 7-755 applies.

4
5 **Uniform Comment**

6 (This is Section 406 of the Uniform Principal and Income Act
7 (1997).)

10 **Variable or floating interest rates.** The reference in
11 subsection (a) to variable or floating interest rate obligations
12 is intended to clarify that, even though an obligation's interest
13 rate may change from time to time based upon changes in an index
14 or other market indicator, an obligation to pay money containing
15 a variable or floating rate provision is subject to this section
16 and is not to be treated as a derivative financial instrument
17 under Section 414.

18 **Discount obligations.** Subsection (b) applies to all
19 obligations acquired at a discount, including short-term
20 obligations such as U.S. Treasury Bills, long-term obligations
21 such as U.S. Savings Bonds, zero-coupon bonds, and discount bonds
22 that pay interest during part, but not all, of the period before
23 maturity. Under subsection (b), the entire increase in value of
24 these obligations is principal when the trustee receives the
25 proceeds from the disposition unless the obligation, when
26 acquired, has a maturity of less than one year. In order to have
27 one rule that applies to all discount obligations, the Act
28 eliminates the provision in the 1962 Act for the payment from
29 principal of an amount equal to the increase in the value of U.S.
30 Series E bonds. The provision for bonds that mature within one
31 year after acquisition by the trustee is derived from the
32 Illinois act. 760 ILCS 15/8 (1996).

34
35 Subsection (b) also applies to inflation-indexed bonds - any
36 increase in principal due to inflation after issuance is
37 principal upon redemption if the bond matures more than one year
38 after the trustee acquires it; if it matures within one year, all
39 of the increase, including any attributable to an inflation
40 adjustment, is income.

42 **Effect of Section 104.** In deciding whether and to what
43 extent to exercise the power to adjust between principal and
44 income granted by Section 104(a), a relevant factor for the
45 trustee to consider is the effect on the portfolio as a whole of
46 having a portion of the assets invested in bonds that do not pay
47 interest currently.

48 **§7-747. Insurance policies and similar contracts**

50

2 This section is intended to relieve a trustee from making
relatively small allocations while preserving the trustee's right
to do so if an allocation is large in terms of absolute dollars.

4
6 For example, assume that a trust's assets, which include a
working interest in an oil well, have a value of \$1,000,000; the
8 net income from the assets other than the working interest is
\$40,000; and the net receipts from the working interest are
10 \$400. The trustee may allocate all of the net receipts from the
working interest to principal instead of allocating 10%, or \$40,
12 to income under Section 411. If the net receipts from the
working interest are \$35,000, so that the amount allocated to
14 income under Section 411 would be \$3,500, the trustee may decide
that this amount is sufficiently significant to the income
16 beneficiary that the allocation provided for by Section 411
should be made, even though the trustee is still permitted under
18 Section 408 to allocate all of the net receipts to principal
because the \$3,500 would increase the net income of \$40,000, as
20 determined before making an allocation under Section 411, by less
than 10%. Section 408 will also relieve a trustee from having to
22 allocate net receipts from the sale of trees in a small woodlot
between principal and income.

24 While the allocation to principal of small amounts under
this section should not be a cause for concern for tax purposes,
26 allocations are not permitted under this section in circumstances
described in Section 104(c) to eliminate claims that the power in
28 this section has adverse tax consequences.

30 **§7-749. Deferred compensation, annuities and similar payments**

32 (a) In this section, "payment" means a payment that a
34 trustee may receive over a fixed number of years or during the
life of one or more individuals because of services rendered or
36 property transferred to the payor in exchange for future
payments. The term includes a payment made in money or property
38 from the payor's general assets or from a separate fund created
by the payor, including a private or commercial annuity, an
40 individual retirement account and a pension, profit-sharing,
stock-bonus or stock-ownership plan.

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

50 (c) If no part of a payment is characterized as interest, a
dividend or an equivalent payment, and all or part of the payment

2 is required to be made, a trustee shall allocate to income 10% of
4 the part that is required to be made during the accounting period
6 and the balance to principal. If no part of a payment is
8 required to be made or the payment received is the entire amount
10 to which the trustee is entitled, the trustee shall allocate the
12 entire payment to principal. For purposes of this subsection, a
14 payment is not "required to be made" to the extent that it is
16 made because the trustee exercises a right of withdrawal.

10 (d) If, to obtain an estate tax marital deduction for a
12 trust, a trustee must allocate more of a payment to income than
14 provided for by this section, the trustee shall allocate to
16 income the additional amount necessary to obtain the marital
18 deduction.

16 (e) This section does not apply to payments to which
18 section 7-750 applies.

20 **Uniform Comment**

22 (This is Section 409 of the Uniform Principal and Income Act
24 (1997).)

26 **Scope.** Section 409 applies to amounts received under
28 contractual arrangements that provide for payments to a third
30 party beneficiary as a result of services rendered or property
32 transferred to the payer. While the right to receive such
34 payments is a liquidating asset of the kind described in Section
40 410 (i.e., "an asset whose value will diminish or terminate
42 because the asset is expected to produce receipts for a period of
44 limited duration"), these payment rights are covered separately
46 in Section 409 because of their special characteristics.

36 Section 409 applies to receipts from all forms of annuities
38 and deferred compensation arrangements, whether the payment will
40 be received by the trust in a lump sum or in installments over a
42 period of years. It applies to bonuses that may be received over
44 two or three years and payments that may last for much longer
46 periods, including payments from an individual retirement account
48 (IRA), deferred compensation plan (whether qualified or not
qualified for special federal income tax treatment), and
insurance renewal commissions. It applies to a retirement plan
to which the settlor has made contributions, just as it applies
to an annuity policy that the settlor may have purchased
individually, and it applies to variable annuities, deferred
annuities, annuities issued by commercial insurance companies,
and "private annuities" arising from the sale of property to
another individual or entity in exchange for payments that are to

2 be made for the life of one or more individuals. The section
3 applies whether the payments begin when the payment right becomes
4 subject to the trust or are deferred until a future date, and it
5 applies whether payments are made in cash or in kind, such as
6 employer stock (in-kind payments usually will be made in a single
7 distribution that will be allocated to principal under the second
8 sentence of subsection (c)).

10 **The 1962 Act.** Under Section 12 of the 1962 Act, receipts
11 from "rights to receive payments on a contract for deferred
12 compensation" are allocated to income each year in an amount "not
13 in excess of 5% per year" of the property's inventory value.
14 While "not in excess of 5%" suggests that the annual allocation
15 may range from zero to 5% of the inventory value, in practice the
16 rule is usually treated as prescribing a 5% allocation. The
17 inventory value is usually the present value of all the future
18 payments, and since the inventory value is determined as of the
19 date on which the payment right becomes subject to the trust, the
20 inventory value, and thus the amount of the annual income
21 allocation, depends significantly on the applicable interest rate
22 on the decedent's date of death. That rate may be much higher or
23 lower than the average long-term interest rate. The amount
24 determined under the 5% formula tends to become fixed and remain
25 unchanged even though the amount received by the trust increases
26 or decreases.

28 **Allocations Under Section 409(b).** Section 409(b) applies to
29 plans whose terms characterize payments made under the plan as
30 dividends, interest, or payments in lieu of dividends or
31 interest. For example, some deferred compensation plans that
32 hold debt obligations or stock of the plan's sponsor in an
33 account for future delivery to the person rendering the services
34 provide for the annual payment to that person of dividends
35 received on the stock or interest received on the debt
36 obligations. Other plans provide that the account of the person
37 rendering the services shall be credited with "phantom" shares of
38 stock and require an annual payment that is equivalent to the
39 dividends that would be received on that number of shares if they
40 were actually issued; or a plan may entitle the person rendering
41 the services to receive a fixed dollar amount in the future and
42 provide for the annual payment of interest on the deferred amount
43 during the period prior to its payment. Under Section 409(b),
44 payments of dividends, interest or payments in lieu of dividends
45 or interest under plans of this type are allocated to income; all
46 other payments received under these plans are allocated to
47 principal.

48 Section 409(b) does not apply to an IRA or an arrangement
49 with payment provisions similar to an IRA. IRAs and similar
50 arrangements are subject to the provisions in Section 409(c).

2 **Allocations Under Section 409(c).** The focus of Section 409,
4 for purposes of allocating payments received by a trust to or
6 between principal and income, is on the payment right rather than
8 on assets that may be held in a fund from which the payments are
10 made. Thus, if an IRA holds a portfolio of marketable stocks and
12 bonds, the amount received by the IRA as dividends and interest
14 is not taken into account in determining the principal and income
16 allocation except to the extent that the Internal Revenue Service
18 may require them to be taken into account when the payment is
20 received by a trust that qualifies for the estate tax marital
22 deduction (a situation that is provided for in Section 409(d)).
24 An IRA is subject to federal income tax rules that require
payments to begin by a particular date and be made over a
specific number of years or a period measured by the lives of one
or more persons. The payment right of a trust that is named as a
beneficiary of an IRA is not a right to receive particular items
that are paid to the IRA, but is instead the right to receive an
amount determined by dividing the value of the IRA by the
remaining number of years in the payment period. This payment
right is similar to the right to receive a unitrust amount, which
is normally expressed as an amount equal to a percentage of the
value of the unitrust assets without regard to dividends or
interest that may be received by the unitrust.

26 An amount received from an IRA or a plan with a payment
28 provision similar to that of an IRA is allocated under Section
30 409(c), which differentiates between payments that are required
32 to be made and all other payments. To the extent that a payment
34 is required to be made (either under federal income tax rules or,
36 in the case of a plan that is not subject to those rules, under
38 the terms of the plan), 10% of the amount received is allocated
to income and the balance is allocated to principal. All other
payments are allocated to principal because they represent a
change in the form of a principal asset; Section 409 follows the
rule in Section 404(2), which provides that money or property
received from a change in the form of a principal asset be
allocated to principal.

40 Section 409(c) produces an allocation to income that is
42 similar to the allocation under the 1962 Act formula if the
44 annual payments are the same throughout the payment period, and
46 it is simpler to administer. The amount allocated to income
48 under Section 409 is not dependent upon the interest rate that is
used for valuation purposes when the decedent dies, and if the
payments received by the trust increase or decrease from year to
year because the fund from which the payment is made increases or
decreases in value, the amount allocated to income will also
increase or decrease.

50

2 (This is Section 410 of the Uniform Principal and Income Act
(1997).)

4 **Prior Acts.** Section 11 of the 1962 Act allocates receipts
6 from "property subject to depletion" to income in an amount "not
8 in excess of 5%" of the asset's inventory value. The 1931 Act
10 has a similar 5% rule that applies when the trustee is under a
12 duty to change the form of the investment. The 5% rule imposes
14 on a trust the obligation to pay a fixed annuity to the income
16 beneficiary until the asset is exhausted. Under both the 1931
18 and 1962 Acts the balance of each year's receipts is added to
20 principal. A fixed payment can produce unfair results. The
22 remainder beneficiary receives all of the receipts from
unexpected growth in the asset, e.g., if royalties on a patent or
copyright increase significantly. Conversely, if the receipts
diminish more rapidly than expected, most of the amount received
by the trust will be allocated to income and little to
principal. Moreover, if the annual payments remain the same for
the life of the asset, the amount allocated to principal will
usually be less than the original inventory value. For these
reasons, Section 410 abandons the annuity approach under the 5%
rule.

24 **Lottery payments.** The reference in subsection (a) to rights
26 to receive payments under an arrangement that does not provide
28 for the payment of interest includes state lottery prizes and
similar fixed amounts payable over time that are not deferred
compensation arrangements covered by Section 409.

30 **§7-751. Minerals, water and other natural resources**

32 (a) To the extent that a trustee accounts for receipts from
34 an interest in minerals or other natural resources pursuant to
36 this section, the trustee shall allocate them as follows.

38 (1) If received as nominal delay rental or nominal annual
rent on a lease, a receipt must be allocated to income.

40 (2) If received from a production payment, a receipt must
42 be allocated to income if and to the extent that the
44 agreement creating the production payment provides a factor
for interest or its equivalent. The balance must be
allocated to principal.

46 (3) If an amount received as a royalty, shut-in-well
48 payment, take-or-pay payment, bonus or delay rental is more
than nominal, 90% must be allocated to principal and the
balance to income.

50

2 (4) If an amount is received from a working interest or any
4 other interest not provided for in paragraph (1), (2) or
(3), 90% of the net amount received must be allocated to
principal and the balance to income.

6 (b) An amount received on account of an interest in water
8 that is renewable must be allocated to income. If the water is
not renewable, 90% of the amount must be allocated to principal
and the balance to income.

10 (c) This Part applies whether or not a decedent or donor
12 was extracting minerals, water or other natural resources before
14 the interest became subject to the trust.

16 (d) If a trust owns an interest in minerals, water or other
18 natural resources on January 1, 2002, the trustee may allocate
20 receipts from the interest as provided in this Part or in the
22 manner used by the trustee before January 1, 2002. If the trust
acquires an interest in minerals, water or other natural
resources after January 1, 2002, the trustee shall allocate
receipts from the interest as provided in this Part.

24 **Uniform Comment**

26 (This is Section 411 of the Uniform Principal and Income Act
28 (1997).)

30 **Prior Acts.** The 1962 Act allocates to principal as a
32 depletion allowance, 27 1/2% of the gross receipts, but not more
34 than 50% of the net receipts after paying expenses. The Internal
36 Revenue Code no longer provides for a 27 1/2% depletion allowance,
38 although the major oilproducing States have retained the 27 1/2%
provision in their principal and income acts (Texas amended its
Act in 1993, but did not change the depletion provision).
Section 9 of the 1931 Act allocates all of the net proceeds
received as consideration for the "permanent severance of natural
resources from the lands" to principal.

40 Section 411 allocates 90% of the net receipts to principal
42 and 10% to income. A depletion provision that is tied to past or
44 present Code provisions is undesirable because it causes a large
46 portion of the oil and gas receipts to be paid out as income. As
48 wells are depleted, the amount received by the income beneficiary
falls drastically. Allocating a larger portion of the receipts
to principal enables the trustee to acquire other income
producing assets that will continue to produce income when the
mineral reserves are exhausted.

2 **Application of Sections 403 and 408.** This section applies
3 to the extent that the trustee does not account separately for
4 receipts from minerals and other natural resources under Section
5 403 or allocate all of the receipts to principal under Section
6 408.

7 **Open mine doctrine.** The purpose of Section 411(c) is to
8 abolish the "open mine doctrine" as it may apply to the rights of
9 an income beneficiary and a remainder beneficiary in receipts
10 from the production of minerals from land owned or leased by a
11 trust. Instead, such receipts are to be allocated to or between
12 principal and income in accordance with the provisions of this
13 Act. For a discussion of the open mine doctrine, see generally
14 3A Austin W. Scott & William F. Fratcher, *The Law of Trusts* §
15 239.3 (4th ed. 1988), and Nutter v. Stockton, 626 P.2d 861 (Okla.
16 1981).

17 **Effective date provision.** Section 9(b) of the 1962 Act
18 provides that the natural resources provision does not apply to
19 property interests held by the trust on the effective date of the
20 Act, which reflects concerns about the constitutionality of
21 applying a retroactive administrative provision to interests in
22 real estate, based on the opinion in the Oklahoma case of
23 Franklin v. Margay Oil Corporation, 153 P.2d 486, 501 (Okla.
24 1944). Section 411(d) permits a trustee to use either the method
25 provided for in this Act or the method used before the Act takes
26 effect. Lawyers in jurisdictions other than Oklahoma may
27 conclude that retroactivity is not a problem as to property
28 situated in their States, and this provision permits trustees to
29 decide, based on advice from counsel in States whose law may be
30 different from that of Oklahoma, whether they may apply this
31 provision retroactively if they conclude that to do so is in the
32 best interests of the beneficiaries.

33
34 If the property is in a State other than the State where the
35 trust is administered, the trustee must be aware that the law of
36 the property's situs may control this question. The outcome
37 turns on a variety of questions: whether the terms of the trust
38 specify that the law of a State other than the situs of the
39 property shall govern the administration of the trust, and
40 whether the courts will follow the terms of the trust; whether
41 the trust's asset is the land itself or a leasehold interest in
42 the land (as it frequently is with oil and gas property); whether
43 a leasehold interest or its proceeds should be classified as real
44 property or personal property, and if as personal property,
45 whether applicable state law treats it as a movable or an
46 immovable for conflict of laws purposes. See 5A Austin W. Scott
47 & William F. Fratcher, *The Law of Trusts* §§ 648, at 531, 533-534;
48 § 657, at 600 (4th ed. 1989).
49
50

2 **§7-752. Timber**

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

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

18 (2) To principal to the extent that the amount of timber
20 removed from the land exceeds the rate of growth of the
22 timber or the net receipts are from the sale of standing
24 timber;

26 (3) To or between income and principal if the net receipts
28 are from the lease of timberland or from a contract to cut
30 timber from land owned by a trust, by determining the amount
32 of timber removed from the land under the lease or contract
34 and applying the rules in paragraphs (1) and (2); or

36 (4) To principal to the extent that advance payments,
38 bonuses and other payments are not allocated pursuant to
40 paragraph (1), (2) or (3).

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

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

(d) If a trust owns an interest in timberland on January 1,
2002, the trustee may allocate net receipts from the sale of
timber and related products as provided in this Part or in the
manner used by the trustee before January 1, 2002. If the trust
acquires an interest in timberland after January 1, 2002, the
trustee shall allocate net receipts from the sale of timber and
related products as provided in this Part.

44 **Uniform Comment**

46 (This is Section 412 of the Uniform Principal and Income Act
48 (1997).)

50 **Scope of section.** The rules in Section 412 are intended to
apply to net receipts from the sale of trees and by-products from

2 harvesting and processing trees without regard to the kind of
trees that are cut or whether the trees are cut before or after a
4 particular number of years of growth. The rules apply to the
sale of trees that are expected to produce lumber for building
6 purposes, trees sold as pulpwood, and Christmas and other
ornamental trees. Subsection (a) applies to net receipts from
8 property owned by the trustee and property leased by the
trustee. The Act is not intended to prevent a tenant in
10 possession of the property from using wood that he cuts on the
property for personal, noncommercial purposes, such as a
12 Christmas tree, firewood, mending old fences or building new
fences, or making repairs to structures on the property.

14 Under subsection (a), the amount of net receipts allocated
to income depends upon whether the amount of timber removed is
16 more or less than the rate of growth. The method of determining
the amount of timber removed and the rate of growth is up to the
18 trustee, based on methods customarily used for the kind of timber
involved.

20 **Application of Sections 403 and 408.** This section applies
22 to the extent that the trustee does not account separately for
net receipts from the sale of timber and related products under
24 Section 403 or allocate all of the receipts to principal under
Section 408. The option to account for net receipts separately
26 under Section 403 takes into consideration the possibility that
timber harvesting operations may have been conducted before the
28 timber property became subject to the trust, and that it may make
sense to continue using accounting methods previously established
30 for the property. It also permits a trustee to use customary
accounting practices for timber operations even if no harvesting
32 occurred on the property before it became subject to the trust.

34 **§7-753. Property not productive of income**

36 (a) If a marital deduction is allowed for all or part of a
38 trust whose assets consist substantially of property that does
not provide the spouse with sufficient income from or use of the
40 trust assets, and if the amounts that the trustee transfers from
principal to income under section 7-704 and distributes to the
42 spouse from principal pursuant to the terms of the trust are
insufficient to provide the spouse with the beneficial enjoyment
44 required to obtain the marital deduction, the spouse may require
the trustee to make property productive of income, convert
46 property within a reasonable time or exercise the power conferred
by section 7-704, subsection (a). The trustee may decide which
48 action or combination of actions to take.

50 (b) In cases not governed by subsection (a), proceeds from
the sale or other disposition of an asset are principal without

2 regard to the amount of income the asset produces during any
3 accounting period.

4
5 **Uniform Comment**

6 (This is Section 413 of the Uniform Principal and Income Act
7 (1997).)

8
9
10 **Prior Acts' Conflict with Uniform Prudent Investor Act.**

11 Section 2(b) of the Uniform Prudent Investor Act provides that
12 "[a] trustee's investment and management decisions respecting
13 individual assets must be evaluated not in isolation but in the
14 context of the trust portfolio as a whole" The
15 underproductive property provisions in Section 12 of the 1962 Act
16 and Section 11 of the 1931 Act give the income beneficiary a
17 right to receive a portion of the proceeds from the sale of
18 underproductive property as "delayed income." In each Act the
19 provision applies on an asset by asset basis and not by taking
20 into consideration the trust portfolio as a whole, which
21 conflicts with the basic precept in Section 2(b) of the Prudent
22 Investor Act. Moreover, in determining the amount of delayed
23 income, the prior Acts do not permit a trustee to take into
24 account the extent to which the trustee may have distributed
25 principal to the income beneficiary, under principal invasion
26 provisions in the terms of the trust, to compensate for
27 insufficient income from the unproductive asset. Under Section
28 104(b)(7) of this Act, a trustee must consider prior
29 distributions of principal to the income beneficiary in deciding
30 whether and to what extent to exercise the power to adjust
31 conferred by Section 104(a).

32
33 **Duty to make property productive of income.** In order to
34 implement the Uniform Prudent Investor Act, this Act abolishes
35 the right to receive delayed income from the sale proceeds of an
36 asset that produces little or no income, but it does not alter
37 existing state law regarding the income beneficiary's right to
38 compel the trustee to make property productive of income. As the
39 law continues to develop in this area, the duty to make property
40 productive of current income in a particular situation should be
41 determined by taking into consideration the performance of the
42 portfolio as a whole and the extent to which a trustee makes
43 principal distributions to the income beneficiary under the terms
44 of the trust and adjustments between principal and income under
45 Section 104 of this Act.

46
47 Trusts for which the value of the right to receive income is
48 important for tax reasons may be affected by Reg. §
49 1.75203(b)(2)(v) *Example (1)*, § 20.75203(b)(2)(v) *Examples (1)* and
50 (2), and § 25.75203(b)(2)(v) *Examples (1)* and (2), which

2 provide that if the income beneficiary does not have the right to
3 compel the trustee to make the property productive, the income
4 interest is considered unproductive and may not be valued
5 actuarially under those sections.

6 **Marital deduction trusts.** Subsection (a) draws on language
7 in Reg. § 20.2056(b)5(f)(4) and (5) to enable a trust for a
8 spouse to qualify for a marital deduction if applicable state law
9 is unclear about the spouse's right to compel the trustee to make
10 property productive of income. The trustee should also consider
11 the application of Section 104 of this Act and the provisions of
12 Restatement of Trusts 3d: Prudent Investor Rule § 240, at 186,
13 app. § 240, at 252 (1992). Example (6) in the Comment to Section
14 104 describes a situation involving the payment from income of
15 carrying charges on unproductive real estate in which Section 104
16 may apply.

17 Once the two conditions have occurred - insufficient
18 beneficial enjoyment from the property and the spouse's demand
19 that the trustee take action under this section - the trustee
20 must act; but instead of the formulaic approach of the 1962 Act,
21 which is triggered only if the trustee sells the property, this
22 Act permits the trustee to decide whether to make the property
23 productive of income, convert it, transfer funds from principal
24 to income, or to take some combination of those actions. The
25 trustee may rely on the power conferred by Section 104(a) to
26 adjust from principal to income if the trustee decides that it is
27 not feasible or appropriate to make the property productive of
28 income or to convert the property. Given the purpose of Section
29 413, the power under Section 104(a) would be exercised to
30 transfer principal to income and not to transfer income to
31 principal.

32 Section 413 does not apply to a so-called "estate" trust,
33 which will qualify for the marital deduction, even though the
34 income may be accumulated for a term of years or for the life of
35 the surviving spouse, if the terms of the trust require the
36 principal and undistributed income to be paid to the surviving
37 spouse's estate when the spouse dies. Reg. §
38 20.2056(c)2(b)(1)(iii).

42 **§7-754. Derivatives and options**

43 (a) In this section, "derivative" means a contract or
44 financial instrument or a combination of contracts and financial
45 instruments that gives a trust the right or obligation to
46 participate in some or all changes in the price of a tangible or
47 intangible asset or group of assets, or changes in a rate, an
48 index of prices or rates or other market indicator for an asset
49 or a group of assets.
50

2 The most comprehensive definition of derivative is in the
3 Exposure Draft of a Proposed Statement of Financial Accounting
4 Standards titled "Accounting for Derivative and Similar Financial
5 Instruments and for Hedging Activities," which was released by
6 the Financial Accounting Standards Board (FASB) on June 20, 1996
7 (No. 162B). The definition in Section 414(a) is derived in part
8 from the FASB definition. The purpose of the definition in
9 subsection (a) is to implement the substantive rule in subsection
10 (b) that provides for all receipts and disbursements to be
11 allocated to principal to the extent the trustee elects not to
12 account for transactions in derivatives under Section 403. As a
13 result, it is much shorter than the FASB definition, which serves
14 much more ambitious objectives.

15 A derivative is frequently described as including futures,
16 forwards, swaps and options, terms that also require definition,
17 and the definition in this Act avoids these terms. FASB used the
18 same approach, explaining in paragraph 65 of the Exposure Draft:

19
20 The definition of *derivative financial instrument* in this
21 Statement includes those financial instruments generally
22 considered to be derivatives, such as forwards, futures,
23 swaps, options, and similar instruments. The Board
24 considered defining a derivative financial instrument by
25 merely referencing those commonly understood instruments,
26 similar to paragraph 5 of Statement 119, which says that
27 "... a derivative financial instrument is a futures,
28 forward, swap, or option contract, or other financial
29 instrument with similar characteristics." However, the
30 continued development of financial markets and innovative
31 financial instruments could ultimately render a definition
32 based on examples inadequate and obsolete. The Board,
33 therefore, decided to base the definition of a derivative
34 financial instrument on a description of the common
35 characteristics of those instruments in order to accommodate
36 the accounting for newly developed derivatives. (Footnote
37 omitted.)

38
39
40 **Marking to market.** A gain or loss that occurs because the
41 trustee marks securities to market or to another value during an
42 accounting period is not a transaction in a derivative financial
43 instrument that is income or principal under the Act - only cash
44 receipts and disbursements, and the receipt of property in
45 exchange for a principal asset, affect a trust's principal and
46 income accounts.

47
48 **Receipt of property other than cash.** If a trustee receives
property other than cash upon the settlement of a derivatives

2 transaction, that property would be principal under Section
404(2).

4 **Options.** Options to which subsection (c) applies include an
6 option to purchase real estate owned by the trustee and a put
8 option purchased by a trustee to guard against a drop in value of
10 a large block of marketable stock that must be liquidated to pay
12 estate taxes. Subsection (c) would also apply to a continuing
14 and regular practice of selling call options on securities owned
by the trust if the terms of the option require delivery of the
securities. It does not apply if the consideration received or
given for the option is something other than cash or property,
such as cross-options granted in a buy-sell agreement between
owners of an entity.

16 **§7-755. Asset-backed securities**

18 (a) In this section, "asset-backed security" means an asset
20 whose value is based upon the right it gives the owner to receive
22 distributions from the proceeds of financial assets that provide
24 collateral for the security. The term includes an asset that
26 gives the owner the right to receive from the collateral
financial assets only the interest or other current return or
only the proceeds other than interest or current return. The
term does not include an asset to which section 7-741 or 7-749
applies.

28 (b) If a trust receives a payment from interest or other
30 current return and from other proceeds of the collateral
32 financial assets, the trustee shall allocate to income the
34 portion of the payment which the payor identifies as being from
interest or other current return and shall allocate the balance
of the payment to principal.

36 (c) If a trust receives one or more payments in exchange
38 for the trust's entire interest in an asset-backed security in
40 one accounting period, the trustee shall allocate the payments to
42 principal. If a payment is one of a series of payments that will
result in the liquidation of the trust's interest in the security
over more than one accounting period, the trustee shall allocate
10% of the payment to income and the balance to principal.

44 **Uniform Comment**

46 (This is Section 415 of the Uniform Principal and Income Act
48 (1997).)

50 **Scope of section.** Typical asset-backed securities include
arrangements in which debt obligations such as real estate

2 mortgages, credit card receivables and auto loans are acquired by
3 an investment trust and interests in the trust are sold to
4 investors. The source for payments to an investor is the money
5 received from principal and interest payments on the underlying
6 debt. An asset-backed security includes an "interest only" or a
7 "principal only" security that permits the investor to receive
8 only the interest payments received from the bonds, mortgages or
9 other assets that are the collateral for the asset-backed
10 security, or only the principal payments made on those collateral
11 assets. An asset-backed security also includes a security that
12 permits the investor to participate in either the capital
13 appreciation of an underlying security or in the interest or
14 dividend return from such a security, such as the "Primes" and
15 "Scores" issued by Americus Trust. An asset-backed security does
16 not include an interest in a corporation, partnership, or an
17 investment trust described in the Comment to Section 402, whose
18 assets consist significantly or entirely of investment assets.
19 Receipts from an instrument that do not come within the scope of
20 this section or any other section of the Act would be allocated
21 entirely to principal under the rule in Section 103(a)(4), and
22 the trustee may then consider whether and to what extent to
23 exercise the power to adjust in Section 104, taking into account
24 the return from the portfolio as whole and other relevant factors.

26 SUBPART 5

28 ALLOCATION OF DISBURSEMENTS DURING ADMINISTRATION OF TRUST

30 §7-761. Disbursements from income

32 A trustee shall make the following disbursements from income
33 to the extent that they are not disbursements to which section
34 7-721, subsection (b), paragraph (2) or (3) applies:

36 (a) One-half of the regular compensation of the trustee and
37 of any person providing investment advisory or custodial services
38 to the trustee;

40 (b) One-half of all expenses for accountings, judicial
41 proceedings or other matters that involve both the income and
42 remainder interests;

44 (c) All of the other ordinary expenses incurred in
45 connection with the administration, management or preservation of
46 trust property and the distribution of income, including
47 interest, ordinary repairs, regularly recurring taxes assessed
48 against principal and expenses of a proceeding or other matter
49 that concerns primarily the income interest; and
50

1 by environmental laws to principal imposes the detriment of those
2 payments over time on both the income and remainder beneficiaries.

4 Under Sections 504(a) and 504(b)(5), a trustee who makes or
5 expects to make a principal disbursement for an environmental
6 expense described in Section 502(a)(7) is authorized to transfer
7 an appropriate amount from income to principal to reimburse
8 principal for disbursements made or to provide a reserve for
9 future principal disbursements.

10 The first part of Section 502(a)(7) is based upon the
11 definition of an "environmental remediation trust" in Treas. Reg.
12 § 301.77014(e)(as amended in 1996). This is not because the Act
13 applies to an environmental remediation trust, but because the
14 definition is a useful and thoroughly vetted description of the
15 kinds of expenses that a trustee owning contaminated property
16 might incur. Expenses incurred to comply with environmental laws
17 include the cost of environmental consultants, administrative
18 proceedings and burdens of every kind imposed as the result of an
19 administrative or judicial proceeding, even though the burden is
20 not formally characterized as a penalty.

21 **Title proceedings.** Disbursements that are made to protect a
22 trust's property, referred to in Section 502(a)(4), include an
23 "action to assure title" that is mentioned in Section 13(c)(2) of
24 the 1962 Act.

25 **Insurance premiums.** Insurance premiums referred to in
26 Section 502(a)(5) include title insurance premiums. They also
27 include premiums on life insurance policies owned by the trust,
28 which represent the trust's periodic investment in the insurance
29 policy. There is no provision in the 1962 Act for life insurance
30 premiums.

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

33 **§7-763. Transfers from income to principal for depreciation**

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

37 (b) A trustee may transfer to principal a reasonable amount
38 of the net cash receipts from a principal asset that is subject
39 to depreciation, but may not transfer any amount for depreciation;

40 (1) Of that portion of real property used or available for
41 use by a beneficiary as a residence or of tangible personal

2 property held or made available for the personal use or
3 enjoyment of a beneficiary;

4 (2) During the administration of a decedent's estate; or

6 (3) Under this section if the trustee is accounting under
7 section 7-743 for the business or activity in which the
8 asset is used.

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

14 **Uniform Comment**

16 (This is Section 503 of the Uniform Principal and Income Act
17 (1997).)

18 **Prior Acts.** The 1931 Act has no provision for
19 depreciation. Section 13(a)(2) of the 1962 Act provides that a
20 charge shall be made against income for "... a reasonable
21 allowance for depreciation on property subject to depreciation
22 under generally accepted accounting principles" That
23 provision has been resisted by many trustees, who do not provide
24 for any depreciation for a variety of reasons. One reason relied
25 upon is that a charge for depreciation is not needed to protect
26 the remainder beneficiaries if the value of the land is
27 increasing; another is that generally accepted accounting
28 principles may not require depreciation to be taken if the
29 property is not part of a business. The Drafting Committee
30 concluded that the decision to provide for depreciation should be
31 discretionary with the trustee. The power to transfer funds from
32 income to principal that is granted by this section is a
33 discretionary power of administration referred to in Section
34 103(b), and in exercising the power a trustee must comply with
35 Section 103(b).

38 One purpose served by transferring cash from income to
39 principal for depreciation is to provide funds to pay the
40 principal of an indebtedness secured by the depreciable
41 property. Section 504(b)(4) permits the trustee to transfer
42 additional cash from income to principal for this purpose to the
43 extent that the amount transferred from income to principal for
44 depreciation is less than the amount of the principal payments.

46 **§7-764. Transfers from income to reimburse principal**

48 (a) If a trustee makes or expects to make a principal
49 disbursement described in this section, the trustee may transfer
50 an appropriate amount from income to principal in one or more

2 accounting periods to reimburse principal or to provide a reserve
3 for future principal disbursements.

4 (b) Principal disbursements to which subsection (a) applies
5 include the following, but only to the extent that the trustee
6 has not been and does not expect to be reimbursed by a 3rd party:

8 (1) An amount chargeable to income but paid from principal
9 because it is unusually large, including extraordinary
10 repairs;

12 (2) A capital improvement to a principal asset, whether in
13 the form of changes to an existing asset or the construction
14 of a new asset, including special assessments;

16 (3) Disbursements made to prepare property for rental,
17 including tenant allowances, leasehold improvements and
18 broker's commissions;

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

24 (5) Disbursements described in section 7-762, subsection
25 (a), paragraph (7).

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

34 **Uniform Comment**

36 (This is Section 504 of the Uniform Principal and Income Act
37 (1997).)

38 **Prior Acts.** The sources of Section 504 are Section 13(b) of
40 the 1962 Act, which permits a trustee to "regularize
41 distributions," if charges against income are unusually large, by
42 using "reserves or other reasonable means" to withhold sums from
43 income distributions; Section 13(c)(3) of the 1962 Act, which
44 authorizes a trustee to establish an allowance for depreciation
45 out of income if principal is used for extraordinary repairs,
46 capital improvements and special assessments; and Section 12(3)
47 of the 1931 Act, which permits the trustee to spread income
48 expenses of unusual amount "throughout a series of years."
Section 504 contains a more detailed enumeration of the

2 circumstances in which this authority may be used, and includes
3 in subsection (b)(4) the express authority to use income to make
4 principal payments on a mortgage if the depreciation charge
5 against income is less than the principal payments on the
6 mortgage.

7 **§7-765. Income taxes**

8
9 (a) A tax required to be paid by a trustee based on
10 receipts allocated to income must be paid from income.

11 (b) A tax required to be paid by a trustee based on
12 receipts allocated to principal must be paid from principal, even
13 if the tax is called an income tax by the taxing authority.

14
15 (c) A tax required to be paid by a trustee on the trust's
16 share of an entity's taxable income must be paid proportionately:

17
18 (1) From income to the extent that receipts from the entity
19 are allocated to income; and

20
21 (2) From principal to the extent that:

22
23 (i) Receipts from the entity are allocated to
24 principal; and

25
26 (ii) The trust's share of the entity's taxable income
27 exceeds the total receipts described in paragraph (1)
28 and subparagraph (i).

29
30 (d) For purposes of this section, receipts allocated to
31 principal or income must be reduced by the amount distributed to
32 a beneficiary from principal or income for which the trust
33 receives a deduction in calculating the tax.

34
35
36 **Uniform Comment**

37
38 (This is Section 505 of the Uniform Principal and Income Act
39 (1997).)

40
41 **Electing Small Business Trusts.** An Electing Small Business
42 Trust (ESBT) is a creature created by Congress in the Small
43 Business Job Protection Act of 1996 (P.L. 104188). For years
44 beginning after 1996, an ESBT may qualify as an S corporation
45 stockholder even if the trustee does not distribute all of the
46 trust's income annually to its beneficiaries. The portion of an
47 ESBT that consists of the S corporation stock is treated as a
48 separate trust for tax purposes (but not for trust accounting
49 purposes), and the S corporation income is taxed directly to that
50

2 portion of the trust even if some or all of that income is
distributed to the beneficiaries.

4 A trust normally receives a deduction for distributions it
6 makes to its beneficiaries. Subsection (d) takes into account
the possibility that an ESBT may not receive a deduction for
8 trust accounting income that is distributed to the
beneficiaries. Only limited guidance has been issued by the
10 Internal Revenue Service, and it is too early to anticipate all
of the technical questions that may arise, but the powers granted
12 to a trustee in Sections 506 and 104 to make adjustments are
probably sufficient to enable a trustee to correct inequities
14 that may arise because of technical problems.

16 **§7-766. Adjustments between principal and income because of taxes**

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

22 (1) Elections and decisions, other than those described in
subsection (b), that the fiduciary makes from time to time
24 regarding tax matters;

26 (2) An income tax or any other tax that is imposed upon the
fiduciary or a beneficiary as a result of a transaction
28 involving or a distribution from the estate or trust; or

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

34 (b) If the amount of an estate tax marital deduction or
36 charitable contribution deduction is reduced because a fiduciary
deducts an amount paid from principal for income tax purposes
38 instead of deducting it for estate tax purposes, and as a result
estate taxes paid from principal are increased and income taxes
40 paid by an estate, trust or beneficiary are decreased, each
estate, trust or beneficiary that benefits from the decrease in
42 income tax shall reimburse the principal from which the increase
in estate tax is paid. The total reimbursement must equal the
44 increase in the estate tax to the extent that the principal used
to pay the increase would have qualified for a marital deduction
46 or charitable contribution deduction but for the payment. The
proportionate share of the reimbursement for each estate, trust
48 or beneficiary whose income taxes are reduced must be the same as
its proportionate share of the total decrease in income tax. An
50 estate or trust shall reimburse principal from income.

2

Uniform Comment

4

(This is Section 506 of the Uniform Principal and Income Act (1997).)

6

8

Discretionary adjustments. Section 506(a) permits the fiduciary to make adjustments between income and principal because of tax law provisions. It would permit discretionary adjustments in situations like these: (1) A fiduciary elects to deduct administration expenses that are paid from principal on an income tax return instead of on the estate tax return; (2) a distribution of a principal asset to a trust or other beneficiary causes the taxable income of an estate or trust to be carried out to the distributee and relieves the persons who receive the income of any obligation to pay income tax on the income; or (3) a trustee realizes a capital gain on the sale of a principal asset and pays a large state income tax on the gain, but under applicable federal income tax rules the trustee may not deduct the state income tax payment from the capital gain in calculating the trust's federal capital gain tax, and the income beneficiary receives the benefit of the deduction for state income tax paid on the capital gain. See generally Joel C. Dobris, *Limits on the Doctrine of Equitable Adjustment in Sophisticated Postmortem Tax Planning*, 66 Iowa L. Rev. 273 (1981).

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Section 506(a)(3) applies to a qualified Subchapter S trust (QSST) whose income beneficiary is required to include a pro rata share of the S corporation's taxable income in his return. If the QSST does not receive a cash distribution from the corporation that is large enough to cover the income beneficiary's tax liability, the trustee may distribute additional cash from principal to the income beneficiary. In this case the retention of cash by the corporation benefits the trust principal. This situation could occur if the corporation's taxable income includes capital gain from the sale of a business asset and the sale proceeds are reinvested in the business instead of being distributed to shareholders.

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Mandatory adjustment. Subsection (b) provides for a mandatory adjustment from income to principal to the extent needed to preserve an estate tax marital deduction or charitable contributions deduction. It is derived from New York's EPTL § 111.2(A), which requires principal to be reimbursed by those who benefit when a fiduciary elects to deduct administration expenses on an income tax return instead of the estate tax return. Unlike the New York provision, subsection (b) limits a mandatory reimbursement to cases in which a marital deduction or a charitable contributions deduction is reduced by the payment of

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2 additional estate taxes because of the fiduciary's income tax
election. It is intended to preserve the result reached in
4 Estate of Britenstool v. Commissioner, 46 T.C. 711 (1966), in
which the Tax Court held that a reimbursement required by the
6 predecessor of EPTL § 111.2(A) resulted in the estate receiving
the same charitable contributions deduction it would have
8 received if the administration expenses had been deducted for
estate tax purposes instead of for income tax purposes. Because
10 a fiduciary will elect to deduct administration expenses for
income tax purposes only when the income tax reduction exceeds
12 the estate tax reduction, the effect of this adjustment is that
the principal is placed in the same position it would have
14 occupied if the fiduciary had deducted the expenses for estate
tax purposes, but the income beneficiaries receive an additional
16 benefit. For example, if the income tax benefit from the
deduction is \$30,000 and the estate tax benefit would have been
18 \$20,000, principal will be reimbursed \$20,000 and the net benefit
to the income beneficiaries will be \$10,000.

20 **Irrevocable grantor trusts.** Under Sections 671-679 of the
Internal Revenue Code (the "grantor trust" provisions), a person
22 who creates an irrevocable trust for the benefit of another
person may be subject to tax on the trust's income or capital
24 gains, or both, even though the settlor is not entitled to
receive any income or principal from the trust. Because this is
26 now a well-known tax result, many trusts have been created to
produce this result, but there are also trusts that are
28 unintentionally subject to this rule. The Act does not require
or authorize a trustee to distribute funds from the trust to the
30 settlor in these cases because it is difficult to establish a
rule that applies only to trusts where this tax result is
32 unintended and does not apply to trusts where the tax result is
intended. Settlers who intend this tax result rarely state it as
34 an objective in the terms of the trust, but instead rely on the
operation of the tax law to produce the desired result. As a
36 result it may not be possible to determine from the terms of the
trust if the result was intentional or unintentional. If the
38 drafter of such a trust wants the trustee to have the authority
to distribute principal or income to the settlor to reimburse the
40 settlor for taxes paid on the trust's income or capital gains,
such a provision should be placed in the terms of the trust. In
42 some situations the Internal Revenue Service may require that
such a provision be placed in the terms of the trust as a
44 condition to issuing a private letter ruling.

46 SUBPART 6

48 MISCELLANEOUS PROVISIONS

50 §7-771. Uniformity of application and construction

