

**Memorandum 98-36****Uniform Principal and Income Act: Progress Report and Partial Draft**

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As suggested at the Commission's March meeting, a "working group" of interested persons met on July 1 to consider technical details and broader issues in the Uniform Principal and Income Act (1997) (UPAIA). This memorandum reports on the working group meeting and offers a partial draft of a California UPAIA that attempts to implement the consensus of the working group to date.

The group consisted of Prof. Edward Halbach (a longtime Commission consultant, currently finishing work as Reporter on the Restatement (3d) of Trusts), Matthew "Sandy" Rae (Chair of the UPAIA Drafting Committee), James L. Deeringer (liaison with the State Bar Estate Planning, Trust and Probate Law Section Executive Committee), James P. Bessolo (Bank of America, California Bankers Association), David W. Lauer (Wells Fargo, CBA), Maurine Padden (CBA), and Stan Ulrich. Although we covered only about half of the UPAIA, the group made good progress through some difficult issues and reached consensus on most points. We have agreed to meet again on August 13 to finish our review.

The group worked from the final (April 20) version of the UPAIA (copy attached to this memorandum, replacing the March 5 version attached to Memorandum 98-19). The group also had before it the written comments of CBA and the State Bar committee, which were attached to Memorandum 98-19 considered at the March Commission meeting, extensive materials prepared for the Miami Institute by E. James Gamble (Co-Reporter on UPAIA), and a New York Legislative Advisory Committee report on UPAIA. (These last two items have not been distributed generally, but are available to Commissioners on request — an excerpt from the NY report, giving a useful summary of their analysis of UPAIA and their proposed modifications, is attached as Exhibit pp. 3-14.).

Also attached is a letter from Luther J. Avery received after the March meeting expressing opposition to adoption of the adjustment power in the uniform act. (See Exhibit p. 1.)

## **Schedule**

As noted, the working group made good progress on the technical issues and also laid the foundation for what we think will be productive discussions of the most controversial issue, the power to adjust between principal and income (discussed below). As noted in Memorandum 98-19, the Commission had agreed to try to expedite consideration of the new uniform act. The State Bar committee had approached the Commission with the idea of reviewing the act early this year and it is also one of the Uniform Commissioners' targeted acts. We had assumed the review, drafting, and comment stages of the project could take place this year, with a bill possible for the 1999 session.

However, significant opposition surfaced, and after the consideration of this matter at the March meeting, we were not so optimistic that progress could be made in time to meet the 1999 schedule. The uniform act is under consideration in a number of states, including New York, so there would be some merit in slowing the study down so that we can see what others are doing. The act is complicated, and does not easily yield its secrets, particularly to those who are not expert practitioners in the estate planning or trust and estates administration fields.

When I suggested we might slow down the project near the conclusion of the working group meeting, however, the group was unanimous that the review, drafting, and comment stages could be completed in time for a 1999 bill, based on the progress made by the working group. Accordingly, the staff recommends that we continue on the expedited track, at least until some difficult issue arises that would merit a slower review.

## **Major Policy Issue — UPAIA Section 104. The Power To Adjust**

The Section 104 power to adjust may bog this study down. This section permits the trustee to equalize treatment of income and remainder beneficiaries where the trustee is investing trust assets for total return by making adjustments between principal and income accounts. Even though the power would apply in an extremely small percentage of trusts, we have received a number of strong objections, as seen in the March meeting materials and Mr. Avery's letter (Exhibit p. 1). (Section 104 and its comment appears on pages 8-15 of the attached copy of the UPAIA.)

However, the general discussion at the working group level gives cause for optimism that there may be a way to meet the objections. The staff has not

attempted to implement any draft approaches at this stage, but it appears that providing a statutory standard based on a unitrust approach and providing a safe harbor for meeting the standard are worth investigating. The discussion at the working group session on this point was spurred, in part, by the report of the New York Legislative Advisory Committee which recommends a 4% per year unitrust rule as a default rule for trusts after the operative date. (The NY committee proposes adopting the Section 104 fiduciary power to adjust as the rule applicable to pre-operative date trusts — for background, see the “Memorandum in Support of the Proposed Legislation” prepared by the NY committee, in Exhibit pp. 3-14.)

The group discussed only the broadest ideas concerning the power to adjust and the unitrust approach. The staff believes that we can probably come up with some solution to the CBA and bar concerns over the standards for exercise of discretion inherent in the power to adjust and the concomitant risk of second-guessing and liability, while also achieving a major goal of the UPAIA that principal and income law be harmonized with the prudent investor portfolio approach to trust investments. This process may result in curtailing the scope of trustee discretion, requiring court authorization, providing standards governing liability, or clarifying the standards that must be satisfied under a Section 104-type rule, or may result in adoption of a unitrust standard, as suggested above — whatever the outcome, we are now optimistic that general agreement is possible and that most of the opposition points can be adequately addressed.

### **Technical Issues**

Technical issues considered by the working group are reflected in the attached partial draft and some are discussed in staff notes following the sections.

One omitted definition should be mentioned. The UPAIA defined “terms of a trust” as follows:

(12) “Terms of a trust” means the manifestation of the intent of a settlor or decedent with respect to the trust, expressed in a manner that admits of its proof in a judicial proceeding, whether by written or spoken words or by conduct.

**UPAIA Comment:** “*Terms of a trust.*” This term was chosen in preference to “terms of the trust instrument” (the phrase used in the 1962 Act) to make it clear that the Act applies to oral trusts as well as those whose terms are expressed in written documents. The

definition is based on the Restatement (Second) of Trusts § 4 (1959) and the Restatement (Third) of Trusts § 4 (Tent. Draft No. 1, 1996). Constructional preferences or rules would also apply, if necessary, to determine the terms of the trust.

The CBA representatives have expressed reservations about this term, finding it confusing and objectionable, since it would question reliance on clear written trust language. Prof. Halbach was clear that this definition expresses the law now, as expressed in the Restatements. While the term is not needed to cover oral trusts, because they are dealt with separately in Probate Code Section 15207, there is a question whether this is a useful statutory definition or would be troublesome as argued by CBA. The staff suggests that we leave the matter for consideration at a later time. The definition, if we are to have one, should apply to the whole Trust Law, and not just the Uniform Principal and Income Act. When the National Conference proposes a Uniform Trust Act, it will likely contain this or a similar provision, and it would be appropriate to consider adoption of the definition at that time.

Respectfully submitted,

Stan Ulrich  
Assistant Executive Secretary

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March 26, 1998

California Law Revision Commission  
4000 Middlefield Road, Suite D-2  
Palo Alto, California 94303-4739

Our File No. 9911.81-35  
Law Revision Commission  
**RECEIVED**

MAR 27 1998

**Re: Uniform Principal and Income Act**

Ladies and Gentlemen:

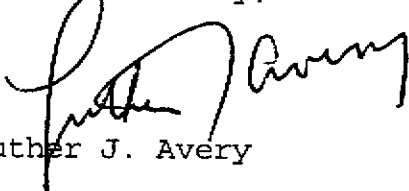
File: L-649

This letter is to register my opposition to adoption of the latest revision of the Uniform Principal and Income Act. In my opinion, the most objectionable provision is Section 104. Adoption of Section 104 will, in my opinion, lead to frequent actions against trustees. The main victim will be individual trustees since corporate trustees are adept at documenting trusts to avoid responsibility. No trustee should exercise the discretion in Section 104 without filing suit for instruction. Thus, all of the beneficiaries will be dragged into court.

The Uniform Management of Institutional Funds Act (Probate Code §§18500 - 18509) accomplishes the discretion of UPIA §104 for institutions in education, religious, charitable and elsewhere to the extent they hold funds under PC §18501 (e). Probate Code §§15400 - 15414 allows the beneficiaries, trustor and trustee as much flexibility as they need to modify the trust.

I also object to other provisions of UPIA, but I am still studying what is the best way to convey my objections.

Yours sincerely,



Luther J. Avery

cc: Jerry A. Kasner



EXHIBIT 2

MEMORANDUM IN SUPPORT OF  
THE PROPOSED LEGISLATION

1. Why is any new legislation needed?

For two reasons. The current New York Principal and Income Act (EPTL 11-2.1) is based largely on the 1962 Uniform Principal and Income Act. Since 1962, there have been substantial changes in economic conditions, investment theory, tax law and trust law. In response to these changes, the National Conference of Commissioners on Uniform State Laws has recently completed a revised Uniform Principal and Income Act.

Secondly, and of greater importance, the Prudent Investor Act (EPTL 11-2.3) recently enacted in New York has demonstrated the need for a new definition of "appropriate benefit currently distributable". Trustees remain constrained by the Principal and Income Act to invest so as to produce receipts defined as trust accounting income. Trustees are therefore unduly limited in their ability to invest for total return as contemplated by the Prudent Investor Act. Particularly in the current investment and tax climate, the current Principal and Income Act is a serious impediment to appropriate fiduciary investment in the interests of both current beneficiaries and remaindermen.

2. What are changes since 1962 justifying new legislation?

A. Economic conditions. It has become apparent that over long time periods equities outperform other forms of investment, although their dividend yields have dropped significantly. Persistent inflation averaging at least 3% (and in double digits in the early 1980's) has eroded the purchasing power of the dollar. Many new investment vehicles such as mutual funds and derivatives have become popular.

B. Investment theory. The concept of total return investing without regard to the distinction between principal and income has become well recognized. Efficient market theory has identified the difficulty of outperforming the market because information affecting price is quickly available and taken into account. The value of diversification to minimize risk has been established.

C. Tax and trust law. Since 1962, The creation of a gift and estate tax unified credit, the million dollar exemption from generation-skipping transfer tax, the QTIP elective marital

deduction, the charitable remainder and section 2702 annuity and unitrust rules, and the development of "Crummey powers" have all encouraged new forms of tax saving trusts. Federal income tax rates for trusts and estates have been compressed so that for tax years beginning in 1997 ordinary income above \$8,100 is taxed at a 39.6% rate. Yet top capital gains rates have recently been reduced to 20%. The law of fiduciary investment has moved from the "legal list" approach to the prudent person rule in 1970 for each trust investment and then in 1995 to the prudent investor rule for the entire trust portfolio.

3. Why should New York adopt the Revised Uniform Principal and Income Act at least for existing trusts?

The Committee considers the revised Uniform Act an improvement on the current New York statute. The revised Uniform Act represents a good deal of careful thought in many areas, particularly with respect to newer types of investment such as derivatives and newer understanding of other investments such as oil and gas and timber. The revised Uniform Act also clarifies other matters such as apportionment at the beginning and end of an income interest.

Existing trusts have been drawn on the basis of the concept of trust accounting income. Many people will presumably still want to use this concept even if a new statute were enacted in New York with respect to future trusts to define benefit without regard to traditional income. If so, there will continue to be a need for an updated statute that defines trust accounting income both for existing trusts and certain future trusts.

4. Why and how should New York enact the adjustment power contained in Section 104 of the revised Uniform Act?

The revised Uniform Act contains many detailed rules to define trust accounting income. The Act also recognizes that its results may not produce a fair sharing of total return investing. For example if a trust is entirely invested in equities, the income is presumably too low a return to meet the needs of the current beneficiary. Section 104 of the revised Uniform Act gives trustees a limited power to adjust as between principal and income to achieve impartial treatment. Such power can enable trustees of existing trusts to invest for total return as encouraged by the Prudent Investor Act. The Committee considers this adjustment power a consequence of the Prudent Investor Act, and recommends that it be placed in the Prudent Investor Act directly, as part of the duty to invest and manage property to make appropriate distributions from trusts governed by an updated uniform act.

5. Is the revised Uniform Act adequate for future trusts?

The Committee considers that the revised Uniform Act represents too conservative an approach to the basic issue - what is the appropriate benefit currently distributable. The primary difficulty with the revised Uniform Act is that it continues the old paradigm of trust accounting income as a measure of appropriate benefit.

Section 104 of the revised Uniform Act provides an adjustment power as between principal and income based on a trustee's determination that the application of the act would otherwise fail to provide an appropriate benefit. Thus the Act itself recognizes that it may be flawed in achieving its intended purpose. Its final application depends on a trustee's judgment as to what would be impartial. Alternatively it would be possible to have a principal and income act which abandoned mechanical definitions of income and gave the trustee power to allocate to income whatever was considered impartial. Neither the revised Uniform Act nor such an alternative approach ultimately provide an adequate standard for trustees of future trusts to apply. In the Committee's view, the law should be rewritten to face the real issue more directly and to provide more guidance to trustees in defining appropriate benefit currently distributable.

6. Why is income an unsatisfactory measure for appropriate benefit currently distributable?

A typical trust purpose is to divide benefit between a current beneficiary and a future beneficiary. Since persons drafting trusts have typically used the concept of trust accounting income to define the benefit distributable to a current beneficiary, a principal and income act is necessary to define trust accounting income so that a trustee will know what benefit to distribute to a current beneficiary.

The Committee has concluded that to use trust accounting income as the measure of current benefit from a trust is arbitrary, manipulable, and contrary to contemporary investment understanding.

A. Arbitrary. Income in some cases is clear enough, as in rent from land, dividends from stocks and interest from bonds. But in other types of receipts, what should be considered income is unclear, as with receipts from oil and gas and timber production, and sales of derivative products. Not every receipt is considered trust accounting income, as with income in respect of a decedent, realized capital gains, certain stock dividends and splits. Trust accounting income and taxable income are not synonymous.

It is difficult to justify forcing a trust to have ordinary income now potentially taxable at a 39.6% top federal rate, when a trust can also produce current benefit from capital gains now potentially taxable at a 20% top federal rate. Moreover, capital gains can be deferred and timed to give more flexibility in the taxation of current benefit.

B. Manipulable. Further, the level of income received depends on investment choice. One company may pay profits as dividends to shareholders, and another company may retain its profits, increasing stock value. Stocks generally pay less income than bonds. For example, the S&P 500 is now paying less than 2%, but stocks in the long run produce a larger total return than bonds, and tend to retain the purchasing power of both income and principal.

Longer term bonds have an "inflation premium" built into the interest they must pay to attract purchasers. To distribute this premium entirely to a current beneficiary sacrifices the long term purchasing power of principal. Thus a trust investment strategy to buy bonds may represent an unconscious decision to favor the current beneficiary over the remainderman in the long run, by in effect invading principal even where the instrument does not expressly permit invasion. This is one example of investment strategy that may produce "too much income" for a current beneficiary.

C. Contrary to modern investment understanding. Non trust investors seek a total return, without prime regard to whether increases in holdings are categorized as principal or income. Investing primarily to obtain capital gain rather than current income can result in "too little income" for the current beneficiary, even though income producing capacity is increased.

To be forced to invest in order to obtain something classifiable as income (so that it can be distributed to a current beneficiary who is supposed to get income) can unduly constrain a trustee in making investment decisions. Over time both the current beneficiary and the remainderman could suffer.

Diversification is recognized as an important strategy to manage and minimize risk. Diversification may include investment in assets producing either "too much" or "too little" income. Diversification may be important to maintain purchasing power of both income and principal over the life of a trust.

Current benefit need not be defined by reference to trust accounting income. In-come need not out-go. A trustee may accumulate in-come considered excessive to distribute currently. Investment need not be required to seek something defined in advance as in-come. A trustee could seek increase, and apportion

the trust property and its increase in value in accordance with the particular trust purposes, without regard to the concept of trust accounting income.

7. Why does the New York Prudent Investor Act require a change in the New York Principal and Income Act?

Effective January 1, 1995, New York enacted a new "Prudent Investor Act" in EPTL 11-2.3. This default rule requires an executor and trustee to pursue an overall investment strategy to enable the fiduciary to make appropriate present and future distributions to or for the benefit of the beneficiaries under the governing instrument, in accordance with risk and return objectives reasonably suited to the entire portfolio. Note that the Act does not speak in terms of principal and income, nor does it require impartiality. Appropriate investment return need not be trust accounting income as defined in the current New York Principal and Income Act, EPTL 11-2.1. Moreover, a governing instrument may favor one beneficiary over another. What then are "appropriate present and future distributions"? The trustee must decide, based on a number of factors specified in the Prudent Investor Act. But a key point implicit in the Act is that trust accounting income need not limit or extend current benefit.

The Prudent Investor Act encourages investing for total return on the portfolio rather than focusing on each particular asset and the income and growth it can generate. Yet typically, trusts still define appropriate current distributions at least partially in terms of income received. Moreover, the Internal Revenue Code continues to require distributions of all income to the current beneficiary of certain types of trusts, for example a QTIP trust or a Qualified Subchapter S trust. In order to make distributions appropriate for a current beneficiary, trustees may remain constrained to invest for a total return which includes some receipts considered as trust accounting income under applicable state law.

8. How could appropriate benefit currently distributable be better defined?

A draftsman can draft around the law of principal and income, and define benefit without dependence on income. For example, the trust can be totally discretionary, or the instrument can give the beneficiary a right within limits to demand benefit, or the current benefit can be a fixed formula such as an annuity or unitrust.

The creator of a trust should consciously consider the purposes and economic effects of particular trust provisions. The

trust definition of appropriate benefit currently distributable will have tremendous impact in this regard. The greater the withdrawal, the less that can remain. For example, should a trust attempt to keep pace with inflation for the remainder beneficiaries, or do the size of the trust, its expected duration and the needs of the current beneficiary make such an effort inappropriate? This is a crucial consideration in designing a trust, and there is no one answer to this question applicable for all trusts.

Continuing to use income to define current benefit is increasingly recognized as a serious problem, based on a shifting understanding of appropriate trust law. The income measure of benefit constricts trustees to operate as they have been, and it leaves to persons drafting trusts the entire responsibility for defining current benefit (without regard to income, if so desired) by drafting around the applicable principal and income act to the extent it seems inappropriate for particular trusts.

The trustee could be given the express discretion to distribute principal or accumulate income within some limits. Constraints on such trustee discretion would presumably include the particular trust terms and purposes, due regard for the respective interests in the trust and the applicable tax laws.

A current beneficiary could also be given a right to withdraw a minimum current benefit. For example, this could be a 5 and 5 power even where not expressed in the instrument, using beneficiary demand as a method of determining annual benefit within the limits of IRC § 2041. A beneficiary could then choose to take less than the amount available, for tax reasons or because the beneficiary does not need the full amount. Conversely, the beneficiary could choose to take more than the trust accounting income if more benefit were needed or if the trust would be taxable on termination (as for example in a generation skipping non-exempt trust).

Another alternative to create additional trust accounting income would be specifically to permit the trustee to place the portfolio into a corporation, which could then decide how much dividend to pay. Presumably the corporation would then be treated as a personal holding company. This could cause distributions to become taxable as dividend even to the extent they are invasions of the portfolio in excess of its income. This "basketing" concept is not contemplated as an option in the revised Uniform Principal and Income Act.

9. Why would a unitrust be a better default method of defining appropriate benefit currently distributable?

As recently argued forcefully by Wolf and Hoisington,<sup>1</sup> the unitrust:

A. forces consideration of trust purposes and investment intentions,

B. sets reasonable expectations for current and future distributions,

C. creates a partnership between the trustee and beneficiaries and potentially eliminates controversy over the trustee's duty of impartiality (which is ultimately undefined in the revised Uniform Principal and Income Act),

D. permits total return investing and fair sharing of return without forcing undue reliance on bonds to produce current income (with resulting damage to the remainder by reason of inflation),

E. permits potential income tax savings by the use of capital and capital gain to provide current benefit, and

F. results in better performance for both the current beneficiary and the remainderman, with a greater likelihood that the purchasing power of both current benefit and remainder will be preserved.

To illustrate, since capital gains are now taxed much more favorably than ordinary income, it would seem a prudent investment strategy to seek total return to a greater degree by capital gains on equities rather than interest income on bonds.

If a one million dollar trust is invested entirely in a bond portfolio earning 6% interest, after 3 years the fund would presumably still be paying the income beneficiary \$60,000 and the principal would still be roughly one million dollars. Inflation will be eroding the value of both principal and income.

On the other hand, if a one million dollar trust had been invested instead entirely in equities on January 1, 1995 when the New York prudent investor act became effective, in the following three years the fund might have produced average annual dividend income of only \$20,000, but the principal could have doubled. If the trust's current benefit had been defined as a 4% unitrust, the

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<sup>1</sup> Wolf, "Defeating the Duty to Disappoint Equally - the Total Return Trust", 32 Real Property, Probate and Trust Journal 45 (Spring 1997); Hoisington, "Modern Trust Design: New Paradigms for the 21st Century", U. of Miami Estate Planning Conference, January 1997.

unitrust distribution could therefore also have doubled, from \$40,000 to \$80,000. Both the current beneficiary and the remainderman would have been better served by a 4% unitrust.

Even in the first year, the proposed 4% unitrust model might provide additional benefit to a current beneficiary, when compared to a traditional income trust. Under the Committee's proposal, the unitrust amount would not be reduced by trustee's commissions, and it would not necessarily be taxable as ordinary income, depending on the trustee's investment and distribution strategy.

For example, if the trust were to earn no ordinary income but achieved a total return by capital gains, the trustee might distribute cash or unappreciated property to satisfy the unitrust amount. Since the trust has no distributable net income (DNI), the unitrust distribution of 4% would be tax free to the beneficiary. Alternatively if the trustee distributed appreciated property to satisfy the unitrust amount, the trust would recognize a capital gain and be required to pay the tax on the gain. The unitrust beneficiary would receive the property with a step up in basis, so that if the beneficiary then sold the property at its distribution value there would be no taxable gain to the beneficiary.

A 4% distribution to the current beneficiary, unreduced by commissions or taxes, would likely be worth more to the beneficiary than a 6% distribution of ordinary income reduced by both commissions and taxes. The remainderman would also be likely to prefer the unitrust because the trustee is enabled to invest for a potential total return sufficient to cover commissions, taxes and inflation.

Of course, to the extent that a trust has distributable net income not exceeding a unitrust amount, the distribution of the unitrust amount in cash or in kind would carry out the DNI to the current beneficiary. Any DNI exceeding the unitrust amount and retained in the trust would be taxed to the trust instead.

10. How should a unitrust be designed as a default rule?

A unitrust could be designed as a fluctuating per cent of principal, based on a periodic determination of some outside measure such as S&P performance or other indicia. For example, using the long term bond rate minus the inflation rate would take into account bond premium for inflation, and keep it with principal. An outside measure might not correlate appropriately with internal performance, particularly if a trust holds non productive property, such as vacant land or a closely held business or a life insurance policy.

The benefit could be a fixed per cent of principal, measured inside the trust. It has been argued that a unitrust amount of 5% would be too high. Studies have indicated that a unitrust of 4% is more likely to preserve principal in the long run. An optimal per cent in the long run may well seem too low for the current beneficiary in the short run and economic conditions may change to make any fixed statutory per cent less desirable, but a 4% unitrust appears to be simple to administer and reasonably safe to prescribe. A governing instrument could designate a different percentage or give to the fiduciary a power to change the formula.

A unitrust rate designed to preserve the purchasing power of both the principal and the annual withdrawal could be at a rate of expected total return less an expected inflation rate. If the assumptions as to expected total return and inflation rate are correct (and ignoring trust expenses and taxes) and if a unitrust rate is increased, the ending value of both the principal and the annual withdrawals may be damaged. This may be necessary in a smaller trust where the needs of the current beneficiary are paramount. On the other hand, if the unitrust rate is reduced, the ending value of principal is substantially increased, while the total value of withdrawals over time is reduced to a lesser extent. This may be appropriate in a credit shelter trust or generation-skipping tax exempt trust, particularly if the current beneficiary has adequate means in any event.

For example, the attached charts demonstrate that a one million dollar unitrust over thirty years would maintain the purchasing power of both principal and the unitrust distributions, assuming a 7% investment total return, a 4% unitrust and 3% inflation (and ignoring taxes and commissions). If the unitrust is increased to 6%, the ending principal falls short of an inflation adjusted principal by more than one million dollars, and after 22 years the further 6% distributions are also reduced below the value of further distributions in a 4% unitrust. If the unitrust is reduced to 2%, its ending principal after thirty years is more than three times the ending principal of a 6% unitrust, while the total 2% unitrust distributions would be roughly 70% of total 4% unitrust distributions, and after thirty years further 2% distributions would exceed the further distributions in a 6% unitrust.

11. What are concerns about a unitrust default rule?

The Committee recognizes there are a number of concerns that could be voiced about adopting a unitrust default rule for trusts. The Committee has taken these concerns into account, and has concluded that the benefits of the unitrust model outweigh these concerns for future trusts, and for present trusts that choose to opt into this model.

A unitrust amount could cause a fluctuating return in volatile times. However, as recommended by Wolf, using an average of market values (for example for the past three years) can significantly reduce fluctuation in annual payout.

Any statutory default unitrust rate could ultimately be inappropriate in future economic conditions. For example, in a protracted "down market" a trust invested substantially in equities would be required to reduce unitrust payments to the current beneficiary. But ultimately, protection of the current beneficiary can not come only from a statutory definition of income (whether as traditional income or as a unitrust amount). Such protection must also come from careful investment of trust principal, possible provision in the trust instrument for invasions of principal if needed, and finally from the court's power to permit invasions of trust principal under EPTL 7-1.6 for a current beneficiary whose support is not otherwise sufficiently provided for.

A 4% unitrust rate could prove to be "too high". There is probably no infallible projection as to a rate that will preserve principal purchasing power and provide a reasonable current benefit, and even if there were, it would probably be too complicated for most people to understand. Particular investments as well as general economic conditions will determine the performance of any trust. It is anticipated, however, based on the historical experience documented by Wolf, that a 4% unitrust rate will tend to preserve the purchasing power of both the current distribution and the remainder if the trust is reasonably invested for total return. Although James Garland has argued that a spending rule should not exceed dividends on equities if the purchasing power of principal is to be preserved as an endowment, it appears that so limiting current benefit would be too drastic for many trust income beneficiaries, particularly in smaller trusts. The Garland analysis does not appear to consider the potential use of capital and capital gains to meet a spending requirement and the impact of the difference in tax rates on ordinary income and capital gains. In any event, if there is any bias in the Committee's recommendations it is in favor of the current beneficiary over the remainderman, on the basis that as a default generalization the trust creator is also more likely to be concerned for the current beneficiary than the remainderman.

A default unitrust amount can be inappropriate for a particular trust, but draftspersons of future trusts can choose a more appropriate rate either for growth or current benefit. For example, a credit shelter trust might use a lower unitrust amount so as to encourage growth free from later estate tax, and a QTIP trust might use a higher unitrust amount so as potentially to compensate for the loss of current benefit in the credit shelter trust and also to reduce principal subject to later estate tax. The Committee's proposal would also allow draftspersons and

trustees to opt out of the unitrust proposal in favor of the Revised Uniform Act proposal.

A unitrust rule can present problems for hard to value assets. The proposed statute provides that annual determinations of value if made reasonably and in good faith shall be conclusive. The proposed statute also avoids difficulties with a residence or tangible personal property in trust, by providing that the right to use such property satisfies the unitrust obligation as to such property. For other non-income producing assets desired to be continued in trust, such as closely held businesses and life insurance policies, it could be necessary to draft around the statute, for example by exempting such assets from inclusion in the principal subject to a unitrust amount distribution. This concern was important in the Committee's decision not to recommend a unitrust rule as a default rule prospectively for existing trusts.

A unitrust rule for future trusts could require greater sophistication by draftspersons and more discussion between grantors and draftspersons to determine whether to rely on the default rule or to draft around it, but this should be seen as desirable.

A change in default rule could catch trust creators and draftspersons unaware, and possibly prejudiced by the effects of the new rule in particular cases. But this could be an argument against any change at all. The Committee's proposal involves some delay in effective date and also the opportunity for particular trusts to opt out of the unitrust default rule.

A unitrust would require a new pattern of trust administration, but it should prove simpler to administer. Trustees may prefer the unitrust to the traditional pattern which requires classification of receipts as income or principal and places the trustee in a position of conflict between current beneficiaries wanting more income and remaindermen wanting to preserve principal. Corporate trustees should be better enabled to deliver satisfactory performance and to avoid surcharge litigation.

A non charitable unitrust may require application of trust income tax rules unfamiliar to many trustees and attorneys. Although the income tax treatment of a non charitable unitrust does not appear unduly complicated, new learning would be required. The unitrust model presents opportunities for income tax savings by the use of capital or capital gain rather than ordinary income to fund unitrust distributions. The taxation of the unitrust model could present problems for certain types of trusts, and in any event it could be changed by the Treasury, for example to create a tier system for distributions similar to the charitable remainder trust rules.

The Committee's proposal is to apply the unitrust model to future estates as well as trusts. The operation of the model could be complicated during estate administration when an estate is left in trust. The unitrust amount for a testamentary trust could be determined from the date of death with an adjustment provision for payments during estate administration.

A unitrust under current New York law would apparently not qualify for the estate tax marital deduction in QTIP or life estate plus general power of appointment type trusts, which require the surviving spouse to receive all the trust income. However, if New York law itself were to define trust income as a reasonable unitrust amount such as 4%, designed to give the spouse an appropriate benefit, it would seem that a marital deduction should then be allowable in accordance with current marital deduction regulations. The Committee expects to obtain clarification from the Treasury Department in this regard. In any event, a QTIP trust could provide that the surviving spouse is to receive the greater of the trust accounting income or a unitrust amount, even if the federal tax law or the New York trust law is not changed.

12. What does the Committee recommend as to unitrusts?

For existing trusts, a unitrust alternative should be elective and not an automatic default rule, particularly because any particular unitrust rate should not be made the same for all existing trusts.

The Committee recommends that a 4% unitrust default model should apply to future trusts and that current and future trustees should have the option to elect into or out of that model, either with consent of beneficiaries or court approval.

A deferred effective date is recommended for proposed EPTL 11-2.4 and 11-2.5, with corresponding amendments to EPTL 11-2.1 and 11-2.3 and SCPA 2308, 2309 and 2312. A delay in effective date should permit draftspersons sufficient time to become better acquainted with the proposed legislation and to determine the extent they wish to rely on it.

## UNIFORM PRINCIPAL AND INCOME ACT

☞ **Staff Note.** As noted in the memorandum, this staff draft covers Articles 1-3 of the Uniform Principal and Income Act (1997), except Section 104 — i.e., the portions of the uniform act that were discussed by the working group on July 1. The new act would start at Section 16320 to avoid overlapping the section numbers of the predecessor RUPA (Prob. Code §§ 16300-16315). Section headings for provisions that are not yet included in this partial draft are included to assist in understanding the scope of the act and to anchor a number of cross-references.

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SEC. \_\_\_\_\_. Chapter 3 (commencing with Section 16320) is added to Part 4 of Division 9 of the Probate Code, to read:

**CHAPTER 3. UNIFORM PRINCIPAL AND INCOME ACT**

**Comment.** This chapter contains the California version of the Uniform Principal and Income Act of 1997. It supersedes the California version of the Revised Uniform Principal and Income Act of 1962 (RUIA) in former Sections 16300-16315. Many provisions in this chapter are the same as or drawn from the Uniform Principal and Income Act of 1997. In Comments to sections in this chapter, a reference to the “Uniform Principal and Income Act (1997),” the “uniform act,” or “UPAIA” means the official text of the uniform act approved by the National Conference of Commissioners on Uniform State Law. Variations from the official text of the uniform act are noted in the Comments to sections in this chapter.

**Article 1. Short Title and Definitions**

**§ 16320. Short title [UPAIA § 101]**

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16320. This chapter may be cited as the Uniform Principal and Income Act.

**Comment.** Section 16320 replaces former Section 16300 (short title of Revised Uniform Principal and Income Act of 1962). Some provisions included in the Uniform Principal and Income Act (1997) are generalized elsewhere in this code. See Sections 2(b) construction of provisions drawn from uniform acts) (*cf.* UPAIA § 601), 11 (severability) (*cf.* UPAIA § 602)

**§ 16321. Application of definitions [UPAIA § 102]**

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16321. Unless the provision or context otherwise requires, the definitions in this article govern the construction of this chapter.

**Comment.** Section 16321 is a standard provision. See, e.g., Section 20. This section continues the introductory clause of former Section 16301. For other definitions applicable to this chapter, see Part 2 (commencing with Section 20) of Division 1. Several definitions in the Uniform Principal and Income Act (1997) are not included in this chapter because they are provided in the general Probate Code definitions. See Sections 24 (“beneficiary” defined), 56 (“person” defined), 84 (“trustee” defined).

**§ 16322. Accounting period [UPAIA § 102(2)]**

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16322. “Accounting period” means a calendar year unless another 12-month period is selected by a fiduciary. The term 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.

**Comment.** Section 16322 is the same as Section 102(2) of the Uniform Principal and Income Act (1997). See also Sections 16323 (“fiduciary” defined), 16325 (“income interest” defined).

**§ 16323. Fiduciary [UPAIA § 102(3)]**

---

16323. “Fiduciary” means a personal representative or a trustee.

**Comment.** Section 16323 is the same in substance as Section 102(3) of the Uniform Principal and Income Act (1997). For the purposes of this chapter, the definition of fiduciary in this section is used instead of the general definition in Section 39. See also Sections 58 (“personal

representative” defined), 84 (“trustee” defined). The second sentence of UPAIA Section 102(3) is omitted as surplus, since the definition of personal representative in Section 58 covers the same persons.

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**§ 16324. Income [UPAIA § 102(4)]**

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16324. “Income” means money or property that a fiduciary 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 Article 5.1 (commencing with Section 16350), 5.2 (commencing with Section 16355), or 5.3 (commencing with Section 16360).

**Comment.** Section 16324 is the same as Section 102(4) of the Uniform Principal and Income Act (1997). See also Sections 62 (“property” defined), 16323 (“fiduciary” defined), 16329 (“principal” defined).

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**§ 16325. Income beneficiary [UPAIA § 102(5)]**

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16325. “Income beneficiary” means a person to whom net income of a trust is or may be payable.

**Comment.** Section 16325 supersedes former Section 16301(a) and is the same as Section 102(5) of the Uniform Principal and Income Act (1997). See also Section 16328 (“net income” defined).

**Background from Uniform Act.** The definitions of income beneficiary (Section 102(5)) and income interest (Section 102(6)) cover both mandatory and discretionary beneficiaries and interests. There are no definitions for “discretionary income beneficiary” or “discretionary income interest” because those terms are not used in the Act.

[Adapted from Unif. Principal and Income Act § 102(5) comment (1997).]

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**§ 16326. Income interest [UPAIA § 102(6)]**

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16326. “Income interest” means the right of an income beneficiary to receive all or part of net income, whether the terms of the trust require it to be distributed or authorize it to be distributed in the trustee’s discretion.

**Comment.** Section 16326 is the same as Section 102(6) of the Uniform Principal and Income Act (1997). See also Sections 16325 (“income beneficiary” defined), 16328 (“net income” defined).

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**§ 16327. Mandatory income interest [UPAIA § 102(7)]**

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16327. “Mandatory income interest” means the right of an income beneficiary to receive net income that the terms of the trust require the fiduciary to distribute.

**Comment.** Section 16327 is the same as Section 102(7) of the Uniform Principal and Income Act (1997). See also Sections 16323 (“fiduciary” defined), 16325 (“income beneficiary” defined), 16328 (“net income” defined).

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**§ 16328. Net income [UPAIA § 102(8)]**

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16328. “Net income” means the total receipts allocated to income during an accounting period minus the disbursements made from income during the accounting period, plus or minus transfers under this chapter to or from income during the accounting period.

**Comment.** Section 16328 is the same as Section 102(8) of the Uniform Principal and Income Act (1997). See also Section 16322 (“accounting period” defined), 16324 (“income” defined).

1     **Background from Uniform Act.** The reference to “transfers under this Act to or from income”  
2 means transfers made under Sections 104(a), 412(b), 502(b), 503(b), 504(a), and 506.  
3     [Adapted from Unif. Principal and Income Act § 102(8) comment (1997).]

#### 4     **§ 16329. Principal [UPAIA § 102(10)]**

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5     16329. “Principal” means property held in trust eventually to be delivered to a  
6 remainder beneficiary.

7     **Comment.** Section 16329 is the drawn from Section 102(10) of the Uniform Principal and  
8 Income Act (1997), but continues language from former Section 16303(b). The reference in the  
9 uniform act to distribution “when the trust terminates” has been omitted as overly restrictive,  
10 since principal distributions may occur before a trust terminates. This section provides only a  
11 general definition — the determination of what constitutes principal in particular circumstances  
12 depends on the application of the rules of this chapter.

13     See also Sections 62 (“property” defined), 16330 (“remainder beneficiary” defined).

14     ☞ **Staff Note.** The working group did not see much value in this definition, particularly in its  
15 more restrictive uniform act language. It could be eliminated without loss. Even in this more  
16 benign form, based on existing Section 16303, it may be too limited within the broader context of  
17 the UPAIA, which applies to both trusts and estates.

#### 18     **§ 16330. Remainder beneficiary [UPAIA § 102(11)]**

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19     16330. “Remainder beneficiary” means a person entitled to receive principal when an  
20 income interest ends.

21     **Comment.** Section 16330 supersedes former Section 16301(c) and is the same as Section  
22 102(11) of the Uniform Principal and Income Act (1997). See also Sections 56 (“person”  
23 defined), 16325 (“income interest” defined), 16329 (“principal” defined).

## 24                     Article 2. General Provisions and Fiduciary Duties

#### 25     **§ 16335. General fiduciary duties [UPAIA § 103]**

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26     16335. (a) In allocating receipts and disbursements to or between principal and income,  
27 and with respect to any matter within the scope of Articles 3 (commencing with Section  
28 16340) and 4 (commencing with Section 16345), a fiduciary:

29         (1) Shall administer a trust or estate in accordance with the terms of the trust or the will,  
30 even if there is a different provision in this chapter.

31         (2) May administer a trust or estate by the exercise of a discretionary power of  
32 administration given to the fiduciary by the terms of the trust or the will, even if the  
33 exercise of the power produces a result different from a result required or permitted by  
34 this chapter, and no inference that the fiduciary has improperly exercised the discretion  
35 arises from the fact that the trustee has made an allocation contrary to a provision of this  
36 chapter.

37         (3) Shall administer a trust or estate in accordance with this chapter if the terms of the  
38 trust or the will do not contain a different provision or do not give the fiduciary a  
39 discretionary power of administration.

40         (4) Shall add a receipt or charge a disbursement to principal to the extent that the terms  
41 of the trust or the will and this chapter do not provide a rule for allocating the receipt or  
42 disbursement to or between principal and income.

(b) In exercising [the power to adjust under Section [104(a)] — *this rule, and alternative approaches, are under consideration*] or a discretionary power of administration regarding a matter within the scope of this chapter, whether granted by the terms of a trust, a will, or this chapter, a fiduciary shall 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. A determination in accordance with this chapter is presumed to be fair and reasonable to all of the beneficiaries.

**Comment.** Section 16335 supersedes former Section 16302 and is the same as Section 103 of the Uniform Principal and Income Act (1997), with the addition of the last clause in subdivision (a)(2), which preserves and generalizes the “no inference” rule in former Section 16302(b).

See also Sections 84 (“trust” defined), 16323 (“fiduciary” defined), 16324 (“income” defined), 16329 (“principal” defined).

**Background from Uniform Act. Prior Act.** The rule in Section 2(a) of the 1962 Act [former Prob. Code § 16302] is restated in Section 103(a), without changing its substance, to emphasize that the Act contains only default rules and that provisions in the terms of the trust are paramount. However, Section 2(a) of the 1962 Act applies only to the allocation of receipts and disbursements to or between principal and income. In this Act, the first sentence of Section 103(a) states that it also applies to matters within the scope of Articles [3] and [4]. Section 103(a)(2) incorporates the rule in Section 2(b) of the 1962 Act that a discretionary allocation made by the trustee that is contrary to a rule in the Act should not give rise to an inference of imprudence or partiality by the trustee.

....

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

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

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

**Duty of impartiality.** Whenever there are two or more beneficiaries, a trustee is under a duty to deal impartially with them. Restatement of Trusts 3d: Prudent Investor Rule § 183 (1992). This rule applies whether the beneficiaries’ interests in the trust are concurrent or successive. If the terms of the trust give the trustee discretion to favor one beneficiary over another, a court will not control the exercise of such discretion except to prevent the trustee from abusing it. *Id.* § 183, comment *a*. “The precise meaning of the trustee’s duty of impartiality and the balancing of

1 competing interests and objectives inevitably are matters of judgment and interpretation. Thus,  
2 the duty and balancing are affected by the purposes, terms, distribution requirements, and other  
3 circumstances of the trust, not only at the outset but as they may change from time to time.” *Id.* §  
4 232, comment *c*.

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

15 [Adapted from Unif. Principal and Income Act § 103 comment (1997).]

16 ☞ **Staff Note.** With respect to trustees, the duty of impartiality set forth in subdivision (b)  
17 overlaps with the general duty in Section 16003 of the Trust Law. This creates an opportunity for  
18 confusion and perhaps for inconsistent interpretation, although on the surface, the two rules  
19 appear consistent. However, the duty in subdivision (b) is more detailed than the general duty,  
20 and drafted to cover administration of decedents’ estates. In the context of this act, subdivision (b)  
21 provides more guidance than the general duty.

22 Section 16003 provides as follows:

23 16003. If a trust has two or more beneficiaries, the trustee has a duty to deal impartially  
24 with them and shall act impartially in investing and managing the trust property, taking into  
25 account any differing interests of the beneficiaries.

## 26 § 16336. [Trustee’s power to adjust] [UPAIA § 104]

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27 16336. *[The major policy issues involved in this section are reserved for future*  
28 *consideration. See Memorandum 98-36.]*

## 29 § 16337. Application of chapter to existing trusts and estates [UPAIA § 605]

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30 16337. This chapter applies to every trust or decedent’s estate existing on January 1,  
31 2000, except as otherwise expressly provided in the will or terms of the trust or in this  
32 chapter.

33 **Comment.** Section 16337 is the same in substance as Section 605 of the Uniform Principal and  
34 Income Act (1997). See also Section 3 (general transitional provisions).

# 35 Article 3. Decedent’s Estate or Terminating Income Interest

## 36 § 16340. Determination and distribution of net income [UPAIA § 201]

---

37 16340. In the decedent’s death, in the case of a decedent’s estate, or after an income  
38 interest in a trust ends, the following rules apply:

39 (a) If property is specifically given to a beneficiary, by will or trust, the fiduciary of the  
40 estate or of the terminating income interest shall perform the following duties:

41 (1) Determine the net income [and principal] of the property as provided in this chapter.  
42 The net income and principal of the property are determined by including all of the  
43 amounts the fiduciary receives or pays with respect to the property, whether the amounts  
44 accrued or became due before, on, or after the decedent’s death or an income interest’s

1 terminating event, and by making a reasonable provision for amounts the fiduciary  
2 believes the estate or terminating income interest may become obligated to pay after the  
3 property is distributed.

4 (2) Reduce income and principal receipts on account of a payment described in Section  
5 16370 or 16371 [501 or 502], except to the extent that the will, the terms of the trust, or  
6 [applicable law] requires payment from other property or to the extent that the fiduciary  
7 recovers [or expects to recover] the payment from a third person.

8 (3) Distribute the net income and principal to the beneficiary who is to receive the  
9 property.

10 (b) After complying with subdivision (a), the fiduciary shall determine the remaining  
11 net income of the decedent's estate or terminating income interest as provided in this  
12 chapter and by performing the following duties:

13 (1) Include in net income all income from property used to discharge liabilities.

14 (2) Pay from income or principal, in the fiduciary's discretion, fees of attorneys,  
15 accountants, and fiduciaries, court costs and other expenses of administration, and interest  
16 on death taxes, except that the fiduciary may pay these expenses from income of property  
17 passing to a trust for which the fiduciary claims an estate tax marital or charitable  
18 deduction only to the extent that the payment of these expenses from income will not  
19 cause the reduction or loss of the deduction.

20 (3) Pay from principal all other disbursements made or incurred in connection with the  
21 settlement of a decedent's estate or the winding up of a terminating income interest,  
22 including debts, funeral expenses, disposition of remains, family allowances, and death  
23 taxes and related penalties that are apportioned to the estate or terminating income  
24 interest by the will, the terms of the trust, or Chapter 8 (commencing with Section 12000)  
25 of Part 10 of Division 7.

26 (c) A specific gift, a general pecuniary gift, an annuity, or a gift for maintenance  
27 distributable under a trust carries with it income and bears interest in the same manner as  
28 a specific devise, a general pecuniary devise, an annuity, or a devise for maintenance  
29 under a will set forth in Chapter 8 (commencing with Section 12000) of Part 10 of  
30 Division 7. For the purpose of this section, a reference in Chapter 8 (commencing with  
31 Section 12000) of Part 10 of Division 7 to the date of the testator's death means the date  
32 of the settlor's death or of the occurrence of some other event on which the distributee's  
33 right to receive the gift depends.

34 (d) A fiduciary shall distribute the remaining net income, reduced by distributions  
35 required by subdivision (c), in the manner provided in Section 16341 to all other  
36 beneficiaries, including a beneficiary who receives a pecuniary amount in trust, even if  
37 the beneficiary holds an unqualified power to withdraw assets from the trust or other  
38 presently exercisable general power of appointment over the trust.

39 **Comment.** Section 16340 is drawn from Section 201 of the Uniform Principal and Income Act  
40 (1997), with a number of modifications to conform with the California rule on specific gifts and  
41 to improve readability. This section supersedes former Section 16305.

42 Subdivisions (a) and (b) invoke rules provided elsewhere in this chapter that apply to trustees.  
43 The uniform act referred specifically to rules "which apply to trustees." See UPAIA Section  
44 201(1)-(2). This language has been omitted to simplify this section, but the concept is the same:  
45 the rules applicable to trustees (and fiduciaries generally) in this chapter are to be applied both in  
46 cases of decedent's estates and terminating income interests under this section.

Subdivision (a) is drawn from UPAIA Section 201(1) and (5). Subdivision (a)(1) combines the first sentence of UPAIA Section 201(1) and the second sentence of UPAIA Section 201(5). Subdivision (a)(2) is the same in substance as the first sentence of UPAIA Section 201(5). Subdivision (a)(3) is the same in substance as the second sentence of UPAIA Section 201(1).

Subdivision (b) is the same in substance as UPAIA Section 201(2).

Subdivision (c) continues former Section 16314 without substantive change. This rule substitutes for UPAIA Section 201(3).

Subdivision (d) is the same in substance as UPAIA Section 201(5).

**Background from Uniform Act.** *Terminating income interests and successive income interests.* A trust that provides for a single income beneficiary and an outright distribution of the remainder ends when the income interest ends. A more complex trust may have a number of income interests, either concurrent or successive, and the trust will not necessarily end when one of the income interests ends. For that reason, the Act speaks in terms of income interests ending and beginning rather than trusts ending and beginning. When an income interest in a trust ends, the trustee's powers continue during the winding up period required to complete its administration. A terminating income interest is one that has ended but whose administration is not complete.

If two or more people are given the right to receive specified percentages or fractions of the income from a trust concurrently and one of the concurrent interests ends, e.g., when a beneficiary dies, the beneficiary's income interest ends but the trust does not. Similarly, when a trust with only one income beneficiary ends upon the beneficiary's death, the trust instrument may provide that part or all of the trust assets shall continue in trust for another income beneficiary. While it is common to think and speak of this (and even to characterize it in a trust instrument) as a "new" trust, it is a continuation of the original trust for a remainder beneficiary who has an income interest in the trust assets instead of the right to receive them outright. For purposes of this Act, this is a successive income interest in the same trust. The fact that a trust may or may not end when an income interest ends is not significant for purposes of this Act.

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

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

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

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

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

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

*Interest on estate taxes.* The IRS agrees that interest on estate and inheritance taxes may be deducted for income tax purposes without having to reduce the estate tax deduction for amounts passing to a charity or surviving spouse, whether the interest is paid from principal or income. Rev. Rul. 93-48, 93-2 C.B. 270. For estates of persons who died before 1998, a fiduciary may not want to deduct for income tax purposes interest on estate tax that is deferred under Section 6166 or 6163 because deducting that interest for estate tax purposes may produce more beneficial results, especially if the estate has little or no income or the income tax bracket is significantly lower than the estate tax bracket. For estates of persons who die after 1997, no estate tax or income tax deduction will be allowed for interest paid on estate tax that is deferred under Section 6166. However, interest on estate tax deferred under Section 6163 will continue to be deductible for both purposes, and interest on estate tax deficiencies will continue to be deductible for estate tax purposes if an election under Section 6166 is not in effect.

Under the 1962 Act, Section 13(c)(5) charges interest on estate and inheritance taxes to principal. The 1931 Act has no provision. Section 501(3) of this Act provides that, except to the extent provided in Section 201(2)(B) or (C), all interest must be paid from income.

[Adapted from Unif. Principal and Income Act § 201 comment (1997).]

**Staff Note.** The working groups spent more time on UPAIA Section 201 than any other aspect of the uniform act discussed at the July 1 conference. The staff has attempted in draft Section 16340 to implement the suggestions of the working group, but further study and drafting will need to take place on this troublesome section. The intent is to preserve California's special rules on distribution of interest and income during administration. Additional work needs to be done to make sure that these rules have been effectively integrated into the uniform act and that all inconsistent rules have been identified and removed.

The rule in subdivision (c), as noted in the Comment, preserves existing Section 16314. This language replaces UPAIA Section 201(3):

(3) A fiduciary shall distribute to a beneficiary who receives a pecuniary amount outright the interest or any other amount provided by the will, the terms of the trust, or applicable law from net income determined under paragraph (2) or from 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.

#### **§ 16341. Distribution to residuary and remainder beneficiaries [UPAIA § 202]**

16341. (a) Each beneficiary described in subdivision (d) of Section 16340 is entitled to receive a portion of the net income equal to the beneficiary's fractional interest in

undistributed principal assets, using values as of the appropriate distribution dates and without reducing the values by any unpaid principal obligations.

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

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

**Comment.** Section 16341 is drawn from parts of Section 202 of the Uniform Principal and Income Act (1997). This section retains the basic rules of the UPAIA section, but omits some unnecessary detail. This section supersedes parts of former Section 16304.

Subdivision (a) is the same in substance as the first sentence of UPAIA Section 202(a), and includes the “unpaid principal obligation” rule from UPAIA Section 202(b)(3). The second sentence of Section 202(a) is not needed because it simply reaffirms that the rule in the first sentence is to be applied when there are more than one distributions:

If a fiduciary makes more than one distribution of assets to beneficiaries to whom this section applies, each beneficiary, including one who does not receive part of the distribution, is entitled, as of each distribution date, to the net income the fiduciary has received after the date of death or terminating event or earlier distribution date but has not distributed as of the current distribution date. [UPAIA § 202(a) 2d sent.]

Subdivision (b) is the same as UPAIA Section 202(c), except that the reference to “person” in the uniform act has been changed to “beneficiary.”

Subdivision (c) is the same as UPAIA Section 202(b)(4).

The following UPAIA rules are not included in Section 16341 because they are already stated in the general rule as set out in subdivision (a):

The beneficiary is entitled to receive a portion of the net income equal to the beneficiary’s fractional interest in the undistributed principal assets immediately before the distribution date, including assets that later may be sold to meet principal obligations. [UPAIA § 202(b)(1).]

The beneficiary’s fractional interest in the undistributed principal assets must be calculated on the basis of the aggregate value of those assets as of the distribution date without reducing the value by any unpaid principal obligation. [UPAIA § 202(b)(3).]

Subdivisions (b)(2) and (d) of UPAIA Section 202 are omitted as unnecessary in view of the special California rules on interest and income accruing during administration. See Sections 12000-12006, 16305. The uniform act provision was added to fill a gap noted by several commentators (see UPAIA § 202 comment) — a gap that had been filled by earlier California legislation, which is unaffected by enactment of this chapter. See, e.g., Section 16340(c) (continuing former Section 16314). For background on former law, see *Recommendation Relating to Interest and Income During Administration*, 19 Cal. L. Revision Comm’n Reports 1019 (1988).

**Background from Uniform Act. 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....

[Adapted from Unif. Principal and Income Act § 202 comment (1997).]

Article 4. Apportionment at Beginning and End of Income Interest

**§ 16345. When right to income begins and ends [UPAIA § 301]**

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16345. (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 at the following times:

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

(2) 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, on the date of the testator's death.

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

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

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

**Comment.** Section 16345 is the same in substance as Section 301 of the Uniform Principal and Income Act (1997). This section supersedes parts of former Section 16304.

See also Sections 24 ("beneficiary" defined), 84 ("trustee" defined), 16324 ("income" defined), 16325 ("income beneficiary" defined), 16326 ("income interest" defined), 16328 ("net income" defined), 16329 ("principal" defined).

**Background from Uniform Act.** *Period during which there is no beneficiary.* The purpose of the second part of subsection (d) is to provide that, at the end of a period during which there is no beneficiary to whom a trustee may distribute income, the trustee must apply the same apportionment rules that apply when a mandatory income interest ends. This provision would apply, for example, if a settlor creates a trust for grandchildren before any grandchildren are born. When the first grandchild is born, the period preceding the date of birth is treated as having ended, followed by a successive income interest, and the apportionment rules in Sections 302 and 303 [Prob. Code §§ 16346-16347] apply accordingly if the terms of the trust do not contain different provisions.

[Adapted from Unif. Principal and Income Act § 301 comment (1997).]

**§ 16346. Apportionment of receipts and disbursements when decedent dies or income interest begins [UPAIA § 302]**

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16346. (a) A trustee shall allocate an income receipt or disbursement other than one to which Section [16340(a)] applies to principal if its due date occurs before a decedent dies in the case of an estate or before an income interest begins in the case of a trust or successive income interest.

(b) A trustee shall allocate an income receipt or disbursement to income if its due date occurs on or after the date on which a decedent dies or an income interest begins and it is a periodic due date. An income receipt or disbursement must be treated as accruing from day to day if its due date is not periodic or it has no due date. The portion of the receipt or

disbursement accruing before the date on which a decedent dies or an income interest begins shall be allocated to principal and the balance shall be allocated to income.

(c) An item of income or an obligation is due on the date the payer is required to make a payment. If a payment date is not stated, there is no due date for the purposes of this chapter. Distributions to shareholders or other owners from an entity to which Section [16350] applies are deemed to be due on the date fixed by the entity for determining who is entitled to receive the distribution or, if no date is fixed, on the declaration date for the distribution. A due date is periodic for receipts or disbursements that must be paid at regular intervals under a lease or an obligation to pay interest or if an entity customarily makes distributions at regular intervals.

**Comment.** Section 16346 is the same in substance as Section 302 of the Uniform Principal and Income Act (1997). This section supersedes parts of former Section 16304.

See also Sections 84 (“trustee” defined), 16324 (“income” defined), 16326 (“income interest” defined), 16329 (“principal” defined).

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

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

**Periodic payments.** Under Section 302, a periodic payment is principal if it is due but unpaid before a decedent dies or before an asset becomes subject to a trust, but the next payment is allocated entirely to income and is not apportioned. Thus, periodic receipts such as rents, dividends, interest, and annuities, and disbursements such as the interest portion of a mortgage payment, are not apportioned. This is the original common law rule. Edwin A. Howes, Jr., *The American Law Relating to Income and Principal* 70 (1905). In trusts in which a surviving spouse is dependent upon a regular flow of cash from the decedent’s securities portfolio, this rule will help to maintain payments to the spouse at the same level as before the settlor’s death. Under the 1962 Act, the pre-death portion of the first periodic payment due after death is apportioned to principal in the case of a testamentary trust or securities bequeathed by will to an inter vivos trust.

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

[Adapted from Unif. Principal and Income Act § 302 comment (1997).]

**§ 16347. Apportionment when income interest ends [UPAIA § 303]**

16347. (a) For the purposes of this section, “undistributed income” means net income received before the date on which an income interest ends. The term does not include an item of income or expense that is due or accrued or net income that has been added or is required to be added to principal under the terms of the trust.

(b) Except as provided in subdivision (c), on the date when a mandatory income interest ends, the trustee shall pay to a mandatory income beneficiary who survives that date, or to the estate of a deceased mandatory income beneficiary whose death causes the interest to end, the beneficiary’s share of the undistributed income that is not disposed of under the terms of the trust.

(c) If immediately before the income interest ends, the beneficiary under subdivision (b) has an unqualified power to revoke more than five percent of the trust, the undistributed income from the portion of the trust that may be revoked shall be added to principal.

(d) When a trustee’s obligation to pay a fixed annuity or a fixed fraction of the value of the trust’s assets ends, the trustee shall prorate the final payment.

**Comment.** Section 16347 is the same in substance as Section 303 of the Uniform Principal and Income Act (1997). This section supersedes parts of former Section 16304.

Subdivision (a) is the same as UPAIA Section 303(a).

Subdivisions (b) and (c) are the same in substance as UPAIA Section 303(b). The provision has been restructured for clarity and some minor wording changes have been made. The “unless” clause in the uniform act provision is stated as an exception in subdivision (c), as recognized in the introductory clause of subdivision (b).

Subdivision (d) is the same as the first part of UPAIA Section 303(c). The last clause of UPAIA Section 303(c) (“if and to the extent required by applicable law to accomplish a purpose of the trust or its settlor relating to income, gift, estate, or other tax requirements”) is omitted as being repetitive of general principles.

See also Sections 84 (“trustee” defined), 16324 (“income” defined), 16325 (“income beneficiary” defined), 16326 (“income interest” defined), 16327 (“mandatory income interest” defined), 16328 (“net income” defined), 16329 (“principal” defined).

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

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

**Example – accrued periodic payments.** The rules in Section 302 and Section 303 work in the following manner: Assume that a periodic payment of rent that is due on July 20 has not been paid when an income interest ends on July 30; the successive income interest begins on July 31, and the rent payment that was due on July 20 is paid on August 3. Under Section 302(a), the July 20 payment is added to the principal of the successive income interest when received. Under Section 302(b), the entire periodic payment of rent that is due on August 20 is income when received by the successive income interest. Under Section 303, neither the income beneficiary of

1 the terminated income interest nor the beneficiary's estate is entitled to any part of either the July  
2 20 or the August 20 payments because neither one was received before the income interest ended  
3 on July 30. The same principles apply to expenses of the trust.

4 *Beneficiary with an unqualified power to revoke.* The requirement in subsection (b) to pay  
5 undistributed income to a mandatory income beneficiary or her estate does not apply to the extent  
6 the beneficiary has an unqualified power to revoke more than five percent of the trust  
7 immediately before the income interest ends. Without this exception, subsection (b) would apply  
8 to a revocable living trust whose settlor is the mandatory income beneficiary during her lifetime,  
9 even if her will provides that all of the assets in the probate estate are to be distributed to the trust.

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

20 [Adapted from Unif. Principal and Income Act § 303 comment (1997).]

## 21 Article 5.1. Allocation of Receipts During Administration 22 of Trust: Receipts from Entities

### 23 § 16350. Character of receipts [UPAIA § 401]

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24 16350. (a) For the purposes of this section, "entity" means a corporation, partnership,  
25 limited liability company, regulated investment company, real estate investment trust,  
26 common trust fund, or any other organization in which a trustee has an interest other than  
27 a trust or estate to which Section 402 [16351] applies, a business or activity to which  
28 Section 403 [16352] applies, or an asset-backed security to which Section 415 [16367]  
29 applies.

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

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

33 (1) Property other than money.

34 (2) Money received in one distribution or a series of related distributions in exchange  
35 for part or all of a trust's interest in the entity.

36 (3) Money received in total or partial liquidation of the entity.

37 (4) Money received from an entity that is a regulated investment company or a real  
38 estate investment trust if the money distributed is a capital gain dividend for federal  
39 income tax purposes.

40 (d) Money is received in partial liquidation in either of the following circumstances:

41 (1) To the extent that the entity, at or near the time of a distribution, indicates that it is a  
42 distribution in partial liquidation.

43 (2) If the total amount of money and property received in a distribution or series of  
44 related distributions is greater than 20 percent of the entity's gross assets, as shown by the  
45 entity's year-end financial statements immediately preceding the initial receipt.

(e) Money is not received in partial liquidation, nor may it be taken into account under paragraph (2) of subdivision (d), to the extent that it does not exceed the amount of income tax that a trustee or beneficiary must pay on taxable income of the entity that distributes the money.

(f) A trustee may rely on a statement made by an entity about the source or character of a distribution if the statement is made at or near the time of distribution by the entity's board of directors or other person or group of persons authorized to exercise powers to pay money or transfer property comparable to those of a corporation's board of directors.

**Comment.** Section 16350 is the same in substance as Section 401 of the Uniform Principal and Income Act (1997). Some minor wording changes have been made.

See also Sections 24 ("beneficiary" defined), 62 ("property" defined), 84 ("trustee" defined),

**Background from Uniform Act.** *Entities to which Section 401 applies.* The reference to partnerships in Section 401(a) is intended to include all forms of partnerships, including limited partnerships, limited liability partnerships, and variants that have slightly different names and characteristics from State to State. The section does not apply, however, to receipts from an interest in property that a trust owns as a tenant in common with one or more co-owners, nor would it apply to an interest in a joint venture if, under applicable law, the trust's interest is regarded as that of a tenant in common.

*Capital gain dividends.* Under the Internal Revenue Code and the Income Tax Regulations, a "capital gain dividend" from a 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 short-term capital loss. As a result, a capital gain dividend does not include any net short-term capital gain, and cash received by a trust because of a net short-term capital gain is income under this Act.

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

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

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

*Other large distributions.* A cash distribution may be quite large (for example, more than 10% but not more than 20% of the entity's gross assets) and have characteristics that suggest it should be treated as principal rather than income. For example, an entity may have received cash from a source other than the conduct of its normal business operations because it sold an investment asset; or because it sold a business asset other than one held for sale to customers in the normal course of its business and did not replace it; or it borrowed a large sum of money and secured the repayment of the loan with a substantial asset; or a principal source of its cash was from assets such as mineral interests, 90% of which would have been allocated to principal if the trust had

owned the assets directly. In such a case the trustee, after considering the total return from the portfolio as a whole and the income component of that return, may decide to exercise the power under Section 104(a) to make an adjustment between income and principal, subject to the limitations in Section 104(c).

[Adapted from Unif. Principal and Income Act § 401 comment (1997).]

☞ **Staff Note.** The working group concluded its July 1 meeting while reviewing the above section. Sections 16351-16375 are placeholders for UPAIA sections to be considered later.

**§ 16351. Distribution from trust or estate [UPAIA § 402]**

**§ 16352. Business and other activities conducted by trustee [UPAIA § 403]**

#### Article 5.2. Allocation of Receipts During Administration of Trust: Receipts Not Normally Apportioned

**§ 16355. Principal receipts [UPAIA § 404]**

**§ 16356. Rental property [UPAIA § 405]**

**§ 16357. Obligation to pay money [UPAIA § 406]**

**§ 16358. Insurance policies and similar contracts [UPAIA § 407]**

#### Article 5.3. Allocation of Receipts During Administration of Trust: Receipts Normally Apportioned

**§ 16360. Insubstantial allocations not required [UPAIA § 408]**

**§ 16361. Deferred compensation, annuities, and similar payments [UPAIA § 409]**

**§ 16362. Liquidating asset [UPAIA § 410]**

**§ 16363. Minerals, water, and other natural resources [UPAIA § 411]**

**§ 16364. Timber [UPAIA § 412]**

**§ 16365. Property not productive of income [UPAIA § 413]**

**§ 16366. Derivatives and options [UPAIA § 414]**

**§ 16367. Asset-backed securities [UPAIA § 415]**

#### Article 6. Allocation of Disbursements During Administration of Trust

**§ 16370. Disbursements from income [UPAIA § 501]**

**§ 16371. Disbursements from principal [UPAIA § 502]**

**§ 16372. Transfers from income to principal for depreciation [UPAIA § 503]**

- 1    **§ 16373. Transfers from income to reimburse principal [UPAIA § 504]**
- 2    **§ 16374. Income taxes [UPAIA § 505]**
- 3    **§ 16375. Adjustments between principal and income because of taxes [UPAIA § 506]**
- 4

## CONFORMING REVISIONS AND REPEALS

### **Corp. Code § 10251 (amended). Common trust funds**

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SEC. \_\_\_\_\_. Section 10251 of the Corporations Code is amended to read:

10251. (a) “Educational institution,” as used in this section, means any nonprofit corporation organized under Chapter 4 (commencing with Section 94400) or Chapter 7 (commencing with Section 94700) of Part 59 of the Education Code or organized under Part 1 (commencing with Section 9000) of this division in effect on December 31, 1979, and designated on or after January 1, 1980, as a nonprofit public benefit corporation, or organized for charitable or eleemosynary purposes under Part 2 (commencing with Section 5110) of this division, or Part 3 (commencing with Section 10200) of this division in effect on December 31, 1979, and designated on or after January 1, 1980, as a nonprofit public benefit corporation for the purpose of establishing, conducting or maintaining an institution offering courses beyond high school and issuing or conferring a diploma or for the purpose of offering or conducting private school instruction on the high school or elementary school level and any charitable trust organized for such purpose or purposes. “Educational institution,” as used in this section, also means the University of California, the California State University, the California Community Colleges, and any auxiliary organization, as defined in Section 89901 of the Education Code, established for the purpose of receiving gifts, property and funds to be used for the benefit of a state college.

(b) It shall be lawful for any educational institution to become a member of a nonprofit corporation incorporated under the laws of any state for the purpose of maintaining a common trust fund or similar common fund in which nonprofit organizations may commingle their funds and property for investment and to invest any and all of its funds, whenever and however acquired, in the common fund or funds; provided that, in the case of funds or property held as fiduciary, the investment is not prohibited by the wording of the will, deed, or other instrument creating the fiduciary relationship.

(c) An educational institution electing to invest in a common fund or funds under this section may elect to receive distributions from each fund in an amount not to exceed for each fiscal year the greater of the income, as ~~defined in Section 16303~~ determined under Uniform Principal and Income Act, Chapter 3 (commencing with Section 16320) of Part 4 of Division 9 of the Probate Code, accrued on its interest in the fund or 10 percent of the value of its interest in the fund as of the last day of its next preceding fiscal year. The educational institution may expend the distribution or distributions for any lawful purpose notwithstanding any general or special law characterizing the distribution, or any part thereof, as principal or income; provided that, in the case of funds or property invested as fiduciary, the expenditure is not prohibited by the wording of the will, deed, or other instrument creating the fiduciary relationship. No such prohibition of expenditure shall be deemed to exist solely because a will, deed, or other instrument, whether executed or in effect before or after the effective date of this section, directs or authorizes the use of only the “income,” or “interest,” or “dividends” or “rents, issues or profits,” or contains words of similar import.

(d) The Corporate Securities Law of 1968 shall not apply to the creation, administration, or termination of common trust funds authorized under this section, or to participation therein.

(e) This section shall become operative on January 1, 1997.

**Comment.** Subdivision (c) of Section 10251 is amended to revise a cross-reference. Former Probate Code Section 16303 contained a broad definition of income relying on cross-references to all other provisions in the former Revised Uniform Principal and Income Act (Prob. Code §§ 16300-16315) that affected determination of income. The new Uniform Principal and Income Act (Prob. Code §§ 16320-16375) does not include a catalog provision like former Section 16303. The basic principle invoked by the cross-reference is the same — the meaning of “income” in subdivision (c) is determined under general principal and income rules applicable to trusts. The details of determining income, however, have changed in a number of respects. See Prob. Code §§ 16320-16375.

**Prob. Code § 1063 (amended). Additional schedule of market value, etc.**

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SEC. \_\_\_\_\_. Section 1063 of the Probate Code is amended to read:

1063. (a) In all accounts, there shall be an additional schedule showing the estimated market value of the assets on hand as of the end of the accounting period, and a schedule of the estimated market value of the assets on hand as of the beginning of the accounting period for all accounts subsequent to the initial account. The requirement of an estimated value of real estate, a closely held business, or other assets without a ready market, may be satisfied by a good faith estimate by the fiduciary.

(b) If there were purchases or other changes in the form of assets occurring during the period of the account, there shall be a schedule showing these transactions. However, no reporting is required for transfers between cash or accounts in a financial institution or money market mutual funds as defined in subdivision (d) of Section 8901.

(c) If an estate of a decedent or a trust will be distributed to an income beneficiary, there shall be a schedule showing an allocation of receipts and disbursements between principal and income.

(d) If there is specifically devised property, there shall be an additional schedule accounting for income, disbursements, and proceeds of sale pursuant to Sections Section 12002 and 16314 subdivision (d) of Section 16304.

(e) If any interest has been paid or is to be paid under Section 12003, 12004, or 12005, or 16314 subdivision (d) of Section 16304, there shall be a schedule showing the calculation of the interest.

(f) If the accounting contemplates a proposed distribution, there shall be a schedule setting forth the proposed distribution, including the allocation of income required under Section 12006. If the distribution requires an allocation between trusts, the allocation shall be set forth on the schedule, unless the allocation is to be made by a trustee after receipt of the assets. If the distribution requires valuation of assets as of the date of distribution, the schedule shall set forth the fair market value of those assets.

(g) If, at the end of the accounting period, there are liabilities of the estate or trust, except current or future periodic payments, including rent, salaries, utilities, or other recurring expenses, there shall be a schedule showing all of the following:

(1) All liabilities which are a lien on estate or trust assets.

(2) Taxes due but unpaid as shown on filed returns or assessments received subsequent to filing of returns.

(3) All notes payable.

(4) Any judgments for which the estate or trust is liable.

(5) Any other material liability.

**Comment.** Subdivisions (d) and (e) of Section 1063 are amended to revise cross-references to former Section 16314. See Section 16304 Comment.

---

☞ **Staff Note.** The full text of the existing California RUPIA (Prob. Code §§ 16300-16315) is set out below for reference purposes. The sections are not shown in strikeout to preserve readability. Comments to repealed sections are necessarily incomplete, because the working group has not completed reviewing the new Uniform Principal and Income Act (1997).

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**Prob. Code §§ 16300-16315 (repealed). Revised Uniform Principal and Income Act**

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SEC. \_\_\_\_\_. Chapter 3 (commencing with Section 16300) of Part 4 of Division 9 of the Probate Code is repealed.

**CHAPTER 3. REVISED UNIFORM PRINCIPAL AND INCOME ACT**

**Comment.** The California version of the Revised Uniform Principal and Income Act of 1962 is superseded by the new Uniform Principal and Income of 1997, set out in Sections 16320-16375.

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**§ 16300 (repealed). Short title**

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16300. This chapter may be cited as the Revised Uniform Principal and Income Act.

**Comment.** Former Section 16300 is superseded by Section 16320 (short title of Uniform Principal and Income Act).

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**§ 16301 (repealed). Definitions**

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16301. As used in this chapter:

(a) “Income beneficiary” means the person to whom income is presently payable or for whom it is accumulated for distribution as income.

(b) “Inventory value” means the cost of property purchased by the trustee and the market value of other property at the time it became subject to the trust, but in the case of a testamentary trust the trustee may use any value finally determined for the purposes of an estate or inheritance tax.

(c) “Remainder beneficiary” means the person entitled to principal, presently or in the future, including income which has been accumulated and added to principal.

**Comment.** The substance of the introductory clause of former Section 16301 is continued in Section 16321 (application of definitions).

Subdivision (a) is superseded by Section 16325.

Subdivision (b) is not continued. See the “Background from Uniform Act” comment below.

Subdivision (c) is superseded by Section 16330.

**Background from Uniform Act.** There is no definition for inventory value in this Act because the provisions in which that term was used in the 1962 Act have either been eliminated (in the case of the underproductive property provision) or changed in a way that eliminates the need for the term (in the case of bonds and other money obligations, property subject to depletion, and the method for determining entitlement to income distributed from a probate estate).

[Adapted from Unif. Principal and Income Act § 102 comment (1997).]

1    **§ 16302 (repealed). Duty of trustee as to receipts and expenditures**

---

2        16302. (a) A trust shall be administered with due regard to the respective interests of  
3 income beneficiaries and remainder beneficiaries. A trust is so administered with respect  
4 to the allocation of receipts and expenditures if a receipt is credited or an expenditure is  
5 charged to income or principal or partly to each in any of the following ways:

6        (1) In accordance with the terms of the trust instrument, notwithstanding contrary  
7 provisions of this chapter.

8        (2) In the absence of any contrary terms of the trust instrument, in accordance with the  
9 provisions of this chapter.

10       (3) If neither paragraph (1) nor (2) is applicable, in accordance with the standard of care  
11 provided in Section 16040 and with what is reasonable and equitable in view of the  
12 interests of those entitled to income as well as of those entitled to principal.

13       (b) If the trust instrument gives the trustee discretion in crediting a receipt or charging  
14 an expenditure to income or principal or partly to each, no inference that the trustee has  
15 improperly exercised such discretion arises from the fact that the trustee has made an  
16 allocation contrary to a provision of this chapter.

17       **Comment.** Former Section 16302 is superseded by Section \_\_\_\_.

18    **§ 16303 (repealed). Income and principal**

---

19       16303. (a) Income is the return in money or property derived from the use of principal,  
20 including return received as any of the following:

21       (1) Rent of real or personal property, including sums received for cancellation or  
22 renewal of a lease.

23       (2) Interest on money lent, including sums received as consideration for the prepayment  
24 of principal except as provided in Section 16307 on bond premium and bond discount.

25       (3) Receipts allocated to income as provided in Section 16304.

26       (4) Income earned during administration of a decedent's estate as provided in Section  
27 16305.

28       (5) Corporate distributions as provided in Section 16306.

29       (6) Accrued increment on bonds or other obligations issued at discount as provided in  
30 Section 16307.

31       (7) Receipts from business and farming operations as provided in Section 16308.

32       (8) Receipts from disposition of natural resources as provided in Section 16309.

33       (9) Receipts from other principal subject to depletion as provided in Section 16310.

34       (10) Receipts from disposition of underproductive property as provided in Section  
35 16311.

36       (b) Principal is the property which has been set aside by the owner or the person legally  
37 empowered so that it is held in trust eventually to be delivered to a remainder beneficiary  
38 while the return or use of the principal is in the meantime taken or received by or held for  
39 accumulation for an income beneficiary. Principal includes the following:

40       (1) Consideration received by the trustee on the sale or other transfer of principal or on  
41 repayment of a loan or as a refund or replacement or change in the form of principal.

42       (2) Proceeds of property taken on eminent domain proceedings.

43       (3) Proceeds of insurance upon property forming part of the principal except proceeds  
44 of insurance upon a separate interest of an income beneficiary.

(4) Receipts allocated to principal as provided in Section 16304.

(5) Stock dividends, receipts on liquidation of a corporation, and other corporate distributions as provided in Section 16306.

(6) Proceeds from the disposition of bonds and other obligations for the payment of money as provided in Section 16307.

(7) Royalties and other receipts from disposition of natural resources as provided in Section 16309.

(8) Receipts from other principal subject to depletion as provided in Section 16310.

(9) Any profit resulting from any change in the form of principal except as provided in Section 16311 on underproductive property.

(10) Receipts from disposition of underproductive property as provided in Section 16311.

(11) Any allowances for depreciation established under Section 16308 and paragraph (2) of subdivision (b) of Section 16312.

**Comment.** Former Section 16303 is superseded by Section \_\_\_\_.

#### **§ 16304 (repealed). When right to income arises; apportionment of income**

---

16304. (a) An income beneficiary is entitled to income from the date specified in the trust instrument or, if none is specified, from the date an item of property becomes subject to the trust. In the case of an item of property becoming subject to a trust by reason of a person's death, it becomes subject to the trust as of the date of the death of the person even though there is an intervening period of administration of the person's estate, except that income on the property during the period of administration is governed by Chapter 8 (commencing with Section 12000) of Part 10 of Division 7, and becomes subject to the trust as it accrues.

(b) Upon property becoming subject to a trust by reason of a person's death:

(1) Receipts due but not paid at the date of death of the person are principal.

(2) Receipts in the form of periodic payments (other than corporate distributions to stockholders), including rent, interest, or annuities, not due at the date of the death of the person shall be treated as accruing from day to day. That portion of the receipt accruing before the date of death is principal and the balance is income.

(c) In all other cases, any receipt from income-producing property is income even though the receipt was earned or accrued in whole or in part before the date when the property became subject to the trust.

(d) If an income beneficiary's right to income terminates by death or in any other manner, income paid to the income beneficiary or received by the trustee before the termination belongs to the income beneficiary or his or her personal representative. All income received by the trustee after such termination shall be paid to the person next entitled to income by the terms of the trust. This subdivision is subject to subdivision (d) of Section 21524 and does not apply to income received by a trustee under subdivision (b) of Section 16305.

(e) Corporate distributions to stockholders shall be treated as due on the day fixed by the corporation for determination of stockholders of record entitled to distribution or, if no date is fixed, on the date of declaration of the distribution by the corporation.

(f) A distribution to a beneficiary of current income is payable not less frequently than annually.

1       **Comment.** Former Section 16304 is superseded by Sections 16340 and 16345-16347.

2       **§ 16305 (repealed). Income earned during administration of decedent's estate**

---

3       16305. (a) Unless the will otherwise provides, income from the property of a  
4       decedent's estate after the death of the testator and before distribution, including income  
5       from property used to discharge liabilities, shall be distributed in the manner set forth in  
6       Chapter 8 (commencing with Section 12000) of Part 10 of Division 7. Income received  
7       by a trustee under this subdivision shall be treated as income of the trust.

8       (b) If an income beneficiary's right to income, including interest payable under Section  
9       12003, terminates by death or in any other manner during the period of probate  
10      administration, income attributable to the period of probate administration, when  
11      subsequently received by the trustee, shall be equitably prorated between the beneficiary  
12      (or his or her personal representative) and the person next entitled to income by the terms  
13      of the trust instrument.

14      **Comment.** Former Section 16305 is superseded by Section 16340.

15      **§ 16306 (repealed). Corporate distributions**

---

16      16306. (a) Corporate distributions of shares of the distributing corporation, including  
17      distributions in the form of a stock split or stock dividend, are principal. A right to  
18      subscribe to shares or other securities issued by the distributing corporation accruing to  
19      stockholders on account of their stock ownership and the proceeds of any sale of the right  
20      are principal.

21      (b) Except to the extent that the corporation indicates that some part of a corporate  
22      distribution is a settlement of preferred or guaranteed dividends accrued since the trustee  
23      became a stockholder or is in lieu of an ordinary cash dividend, a corporate distribution is  
24      principal if the distribution is pursuant to any of the following:

25          (1) A call of shares.

26          (2) A merger, consolidation, reorganization, or other plan by which assets of the  
27          corporation are acquired by another corporation.

28          (3) A total or partial liquidation of the corporation, including any distribution which the  
29          corporation indicates is a distribution in total or partial liquidation or any distribution of  
30          assets, other than cash, pursuant to a court decree or final administrative order by a  
31          government agency ordering distribution of the particular assets.

32      (c) In the case of a regulated investment company or a trust qualifying and electing to  
33      be taxed under federal law as a real estate investment trust:

34          (1) Distributions made from ordinary income are income.

35          (2) All other distributions, including distributions from capital gains, depreciation, or  
36          depletion, whether made in the form of cash, an option to take new stock or cash, or an  
37          option to purchase additional shares, are principal.

38      (d) Except as provided in subdivisions (a), (b), and (c), all corporate distributions are  
39      income, including cash dividends, distributions of or rights to subscribe to shares or  
40      securities or obligations of corporations other than the distributing corporation, and the  
41      proceeds of the rights or property distributions. Except as provided in subdivisions (b)  
42      and (c), if the distributing corporation gives a stockholder an option to receive a  
43      distribution either in cash or in its own shares, the distribution chosen is income.

(e) The trustee may rely upon any statement of the distributing corporation as to any fact relevant under any provision of this chapter concerning the source or character of dividends or distributions of corporate assets.

**Comment.** Former Section 16306 is superseded by Section 16350.

#### **§ 16307 (repealed). Bonds and other obligations for payment of money**

---

16307. (a) Bonds or other obligations for the payment of money are principal at their inventory value, except as provided in subdivision (b) for discount bonds. No provision shall be made for amortization of bond premiums or for accumulation for discount. The proceeds of sale, redemption, or other disposition of the bonds or obligations are principal.

(b) The increment in value of a bond or other obligation for the payment of money payable at a future time in accordance with a fixed schedule of appreciation in excess of the price at which it was issued is distributable as income. The increment in value is distributable to the beneficiary who was the income beneficiary at the time of increment from the first principal cash available or, if none is available, when realized by sale, redemption, or other disposition. Whenever unrealized increment is distributed as income but out of principal, the principal shall be reimbursed for the increment when realized.

**Comment.** Former Section 16307 is superseded by Section \_\_\_\_.

#### **§ 16308 (repealed). Business and farming operations**

---

16308. (a) If a trustee uses any part of the principal in the operation of a business, including an agricultural or farming operation, of which the settlor was a sole proprietor or a partner, the net profits and losses of the business shall be computed in accordance with recognized methods of accounting for a comparable business. Net profits from a business are income. Net losses from a business do not reduce other trust income for the fiscal or calendar year during which they occur but shall be carried into subsequent fiscal or calendar years and reduce the net profits of the business for those years.

(b) Subdivision (a) is subject to the provisions of Section 16313 and for this purpose any property of the business or agricultural or farming operation shall be deemed to be “trust property” within the meaning of Section 16313.

**Comment.** Former Section 16308 is superseded by Section \_\_\_\_.

#### **§ 16309 (repealed). Natural resources**

---

16309. (a) If any part of the principal consists of a right to receive royalties, overriding or limited royalties, working interests, production payments, net profit interests, or other interests in minerals or other natural resources in, on, or under land, the receipts from taking the natural resources from the land shall be allocated as follows:

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

(2) If received from a production payment, the receipts are income to the extent of any factor for interest or its equivalent provided in the governing instrument. There shall be allocated to principal the fraction of the balance of the receipts which the unrecovered cost of the production payment bears to the balance owed on the production payment,

1 exclusive of any factor for interest or its equivalent. The receipts not allocated to  
2 principal are income.

3 (3) If received as a royalty, overriding or limited royalty, or bonus, or from a working,  
4 net profit, or any other interest in minerals or other natural resources, receipts not  
5 provided for in paragraphs (1) and (2) shall be apportioned on a yearly basis in  
6 accordance with this paragraph whether or not any natural resource was being taken from  
7 the land at the time the trust was established. The receipts shall be allocated entirely to  
8 income or apportioned between income and principal as the trustee in its discretion may  
9 determine, but the amount added to principal as an allowance for depletion may not  
10 exceed the lesser of (A) the percentage of gross receipts allowed as a deduction for  
11 depletion in computing taxable income for federal income tax purposes or (B) 50 percent  
12 of the net receipts remaining after payment of expenses, direct and indirect, computed  
13 without allowance for depletion.

14 (b) This section does not apply to timber, water, soil, sod, dirt, turf, or mosses.

15 **Comment.** Former Section 16309 is superseded by Section \_\_\_\_.

#### 16 **§ 16310 (repealed). Other property subject to depletion**

---

17 16310. If the principal consists of property subject to depletion, other than property  
18 subject to Section 16309, including land from which merchantable timber may be  
19 removed and, when subject to depletion or amortization, leaseholds, patents, copyrights,  
20 royalty rights, and rights to receive payments on a contract for deferred compensation,  
21 receipts from the property shall be allocated entirely to income or apportioned between  
22 income and principal as the trustee in its discretion may determine, but in no event shall  
23 the amount allocated to principal exceed a reasonable allowance for depletion or  
24 amortization.

25 **Comment.** Former Section 16310 is superseded by Section \_\_\_\_.

#### 26 **§ 16311 (repealed). Underproductive property**

---

27 16311. (a) Except as otherwise provided in this section, a portion of the net proceeds of  
28 sale of any part of principal which has not produced an average net income of at least 1  
29 percent per year of its inventory value for more than a year, including as income the value  
30 of any beneficial use of the property by the income beneficiary, shall be treated as  
31 delayed income to which the income beneficiary is entitled as provided in this section.  
32 The net proceeds of sale are the gross proceeds received, including the value of any  
33 property received in substitution for the property disposed of, less the expenses, including  
34 capital gains tax, if any, incurred in disposition and less any carrying charges paid while  
35 the property was underproductive.

36 (b) The sum allocated as delayed income is the difference between the net proceeds and  
37 the amount which, had it been invested at simple interest at 5 percent per year while the  
38 property was underproductive, would have produced the net proceeds. This sum, plus any  
39 carrying charges and expenses previously charged against income while the property was  
40 underproductive, less any income received by the income beneficiary from the property  
41 and less the value of any beneficial use of the property by the income beneficiary, is  
42 income, and the balance is principal.

(c) If principal subject to this section is disposed of by conversion into property which cannot be apportioned easily, including land or mortgages, (for example, real property acquired by or in lieu of a foreclosure), the income beneficiary is entitled to the net income from any property or obligation into which the original principal is converted while the substituted property or obligation is held. If within five years after the conversion the substituted property has not been further converted into easily apportionable property, no allocation as provided in this section shall be made.

(d) This section does not apply to securities listed on a national securities exchange or traded over the counter if the securities are held in a broadly diversified portfolio designed to produce a reasonable return appropriate to the purposes of the trust.

**Comment.** Former Section 16311 is not continued. See \_\_\_\_.

#### **§ 16312 (repealed). Charges against income and principal**

---

16312. (a) After determining income and principal in accordance with the terms of the trust instrument or with this chapter, the trustee shall charge to income or principal expenses and other charges as provided in this section.

(b) The following charges shall be made against income:

(1) Ordinary expenses incurred in connection with the administration, management, or preservation of the trust property, including regularly recurring taxes assessed against any portion of the principal, water rates, premiums on insurance taken upon the interests of the income beneficiary, remainder beneficiary, or trustee, interest paid by the trustee, and ordinary repairs.

(2) The trustee in its discretion may make a reasonable allowance for depreciation on property subject to depreciation under generally accepted accounting principles, but no allowance shall be made for depreciation of that portion of any real property used by a beneficiary as a residence.

(3) One-half of court costs, attorney's fees, and other fees on periodic judicial accounting, unless the court directs otherwise.

(4) Court costs, attorney's fees, and other fees on other accountings or judicial proceedings if the matter primarily concerns the income interest, unless the court directs otherwise.

(5) One-half of the trustee's regular compensation, whether based on a percentage of principal or income, unless the court directs otherwise.

(6) All expenses reasonably incurred for current management of principal and application of income.

(7) Any tax levied upon receipts defined as income under this part or the trust instrument and payable by the trustee.

(c) If charges against income are of unusual amount, the trustee may by means of reserves or other reasonable means charge them over a reasonable period of time and withhold from distribution sufficient sums to regularize distributions.

(d) The following charges shall be made against principal:

(1) Trustee's compensation not chargeable to income under paragraphs (4) and (5) of subdivision (b), special compensation of trustees, expenses reasonably incurred in connection with principal, court costs and attorney's fees primarily concerning matters of principal, and trustee's compensation computed on principal as an acceptance, distribution, or termination fee.

(2) Charges not provided for in subdivision (b), including the cost of investing and reinvesting principal, the payments on principal of an indebtedness (including a mortgage amortized by periodic payments of principal), expenses for preparation of property for rental or sale, and, unless the court directs otherwise, expenses incurred in maintaining or defending any action or proceeding to construe the trust or protect it or the property or assure the title of any trust property.

(3) Extraordinary repairs or expenses incurred in making a capital improvement to principal, including special assessments, but a trustee may establish an allowance for depreciation out of income to the extent permitted by paragraph (2) of subdivision (b) and by Section 16308.

(4) Any tax levied upon profit, gain, or other receipts allocated to principal notwithstanding denomination of the tax as an income tax by the taxing authority.

(5) If an estate or inheritance tax is levied in respect of a trust in which both an income beneficiary and a remainder beneficiary have an interest, any amount apportioned to the trust, including penalties, even though the income beneficiary also has rights in the principal.

**Comment.** Former Section 16312 is superseded by Section \_\_\_\_.

---

**§ 16313 (repealed). Reserve or allowance for depreciation or depletion;**

---

16313. The trustee is not required to set aside a reserve or allowance from trust income for depreciation or depletion of, or to amortize, any trust property unless the trust instrument expressly requires a reserve or allowance. Nothing in this chapter prevents a trustee in its discretion from establishing a reserve or allowance, or from continuing any previous practice of maintaining a reserve or allowance.

**Comment.** Former Section 16313 is superseded by Section \_\_\_\_.

---

**§ 16314 (repealed). Income and interest on trust distributions**

---

16314. (a) A specific gift, a general pecuniary gift, an annuity, or a gift for maintenance distributable under a trust carries with it income and bears interest in the same manner as a specific devise, a general pecuniary devise, an annuity, or a devise for maintenance under a will set forth in Chapter 8 (commencing with Section 12000) of Part 10 of Division 7.

(b) For the purpose of this section, a reference in Chapter 8 (commencing with Section 12000) of Part 10 of Division 7 to the date of the testator's death means the date of the settlor's death or other event upon which the distributee's right to receive the gift occurs.

**Comment.** Former Section 16314 is continued in Section 16350(c) without substantive change. See Section 16350 Comment.

---

**§ 16315 (repealed). Application to trusts created before July 1, 1989**

---

16315. The changes made in Sections 16304 and 16305, and the addition of Section 16314, by Chapter 1199 of the Statutes of 1988 apply to a trust created before July 1, 1989, but the changes and addition apply to the trust as if created on that date and do not affect any aspect of the trust administration that occurred, or rights of beneficiaries that existed, before that date.

**Comment.** Former Section 16315 is not continued.

1   ☞ **Staff Note.** This section will need further analysis to determine whether it needs to be  
2   continued in the new law.  
3

---

4   **Prob. Code § 17351 (amended). Removal of trust from continuing jurisdiction**

---

5   SEC. \_\_\_\_\_. Section 17351 of the Probate Code is amended to read:

6   17351. (a) If any of the trustees of a trust described in Section 17350 is a trust  
7   company, the trust shall be removed from continuing court jurisdiction as provided in this  
8   section. Within six months after the initial funding of the trust, the trustee shall give a  
9   notice of removal of the trust from continuing court jurisdiction to each beneficiary.  
10   Notice of removal shall be sent by registered or certified mail or by first-class mail, but  
11   notice sent by first- class mail is effective only if an acknowledgment of receipt of notice  
12   is signed by the beneficiary and returned to the trustee.

13   (b) The notice of removal of the trust from continuing court jurisdiction shall contain  
14   the following:

15   (1) A statement that as of January 1, 1983, the law was changed to remove the necessity  
16   for continuing court jurisdiction over the trust.

17   (2) A statement that Section 17200 of the Probate Code gives any beneficiary the right  
18   to petition a court to determine important matters relating to the administration of the  
19   trust.

20   (3) A copy of the text of Sections 17200 and 17201.

21   (4) A statement that each income beneficiary, as defined in ~~subdivision (a) of Section~~  
22   ~~16301~~ Section 16325, is entitled to an annual statement of the principal and income  
23   receipts and disbursements of the trust and that any other beneficiary is entitled to such  
24   information upon written request to the trustee.

25   (5) The name and location of the court in the county in which it is appropriate to file a  
26   petition pursuant to Section 17200, the name and location of the court that had  
27   jurisdiction over the administration of the decedent's estate, and a statement that it is  
28   appropriate to file a petition pursuant to Section 17200 with either court.

29   (c) The trustee shall file with the court that had jurisdiction over the administration of  
30   the decedent's estate proof of giving notice under this section within seven months after  
31   the initial funding of the trust.

32   **Comment.** Subdivision (b)(4) of Section 17351 is amended to correct a cross-reference. The  
33   definition in former Section 16301(a) is superseded by Section 16325. This is a technical,  
34   nonsubstantive change.

35   **Prob. Code § 21524 (amended). Marital deduction trusts**

---

36   SEC. \_\_\_\_\_. Section 21524 of the Probate Code is amended to read:

37   21524. If a marital deduction gift is made in trust, in addition to the other provisions of  
38   this chapter, each of the following provisions also applies to the marital deduction trust:

39   (a) The transferor's spouse is the only beneficiary of income or principal of the marital  
40   deduction property as long as the spouse is alive. Nothing in this subdivision precludes  
41   exercise by the transferor's spouse of a power of appointment included in a trust that  
42   qualifies as a general power of appointment marital deduction trust.

1 (b) Subject to subdivision (d), the transferor's spouse is entitled to all of the income of  
2 the marital deduction property not less frequently than annually, as long as the spouse is  
3 alive.

4 (c) The transferor's spouse has the right to require that the trustee of the trust make  
5 unproductive marital deduction property productive or to convert it into productive  
6 property within a reasonable time.

7 (d) Notwithstanding ~~subdivision (d) of Section 16304~~ \_\_\_\_\_, in the case  
8 of qualified terminable interest property under Section 2056(b)(7) or Section 2523(f) of  
9 the Internal Revenue Code, on termination of the interest of the transferor's spouse in the  
10 trust all of the remaining accrued or undistributed income shall pass to the estate of the  
11 transferor's spouse, unless the instrument provides a different disposition that qualifies  
12 for the marital deduction.

13 **Comment.** Subdivision (d) of Section 21524 \_\_\_\_\_.  
14 \_\_\_\_\_

# UNIFORM PRINCIPAL AND INCOME ACT (1997)

Drafted by the

NATIONAL CONFERENCE OF COMMISSIONERS  
ON UNIFORM STATE LAWS

and by it

APPROVED AND RECOMMENDED FOR ENACTMENT  
IN ALL THE STATES

at its

ANNUAL CONFERENCE  
MEETING IN ITS ONE-HUNDRED-AND-SIXTH YEAR  
IN SACRAMENTO, CALIFORNIA  
JULY 25 – AUGUST 1, 1997

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ON UNIFORM STATE LAWS

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April 20, 1998

## **UNIFORM PRINCIPAL AND INCOME ACT (1997)**

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# UNIFORM PRINCIPAL AND INCOME ACT (1997)

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# UNIFORM PRINCIPAL AND INCOME ACT (1997)

## PREFATORY NOTE

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

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

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

## Revision of the 1931 and 1962 Acts

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

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

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

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

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

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

1 investment activities in rental real estate, natural resources, timber, and derivatives.  
2 Section 403.

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

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

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

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

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

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

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

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

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

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

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

27 (5) The 1962 Act rule for "property subject to depletion," (patents, copyrights,  
28 royalties, and the like), which provides that a trustee may allocate up to 5% of the asset's  
29 inventory value to income and the balance to principal, has been replaced by a rule that  
30 allocates 90% of the amounts received to principal and the balance to income. Section  
31 410.

32 (6) The percentage used to allocate amounts received from oil and gas has been  
33 changed – 90% of those receipts are allocated to principal and the balance to income.  
34 Section 411.

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

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

### 39 40 **Coordination with the Uniform Prudent Investor Act**

41 The law of trust investment has been modernized. See Uniform Prudent Investor  
42 Act (1994); Restatement (Third) of Trusts: Prudent Investor Rule (1992) (hereinafter  
43 Restatement of Trusts 3d: Prudent Investor Rule). Now it is time to update the principal  
44 and income allocation rules so the two bodies of doctrine can work well together. This  
45 revision deals conservatively with the tension between modern investment theory and

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

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



**UNIFORM PRINCIPAL AND INCOME ACT (1997)**

**[ARTICLE] 1**

**DEFINITIONS AND FIDUCIARY DUTIES**

**SECTION 101. SHORT TITLE.** This [Act] may be cited as the Uniform Principal and Income Act (1997).

**SECTION 102. DEFINITIONS.** In this [Act]:

(1) “Accounting period” means a calendar year unless another 12-month period is selected by a fiduciary. The term 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.

(2) “Beneficiary” includes, in the case of a decedent’s estate, an heir [, legatee,] and devisee and, in the case of a trust, an income beneficiary and a remainder beneficiary.

(3) “Fiduciary” means a personal representative or a trustee. The term includes an executor, administrator, successor personal representative, special administrator, and a person performing substantially the same function.

(4) “Income” means money or property that a fiduciary 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 [Article] 4.

(5) “Income beneficiary” means a person to whom net income of a trust is or may be payable.

(6) “Income interest” means the right of an income beneficiary to receive all or part of net income, whether the terms of the trust require it to be distributed or authorize it to be distributed in the trustee’s discretion.

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

(8) “Net income” means the total receipts allocated to income during an accounting period minus the disbursements made from income during the period, plus or minus transfers under this [Act] to or from income during the period.

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

1 (10) “Principal” means property held in trust for distribution to a remainder  
2 beneficiary when the trust terminates.

3 (11) “Remainder beneficiary” means a person entitled to receive principal when  
4 an income interest ends.

5 (12) “Terms of a trust” means the manifestation of the intent of a settlor or  
6 decedent with respect to the trust, expressed in a manner that admits of its proof in a  
7 judicial proceeding, whether by written or spoken words or by conduct.

8 (13) “Trustee” includes an original, additional, or successor trustee, whether or  
9 not appointed or confirmed by a court.

### 10 **Comment**

11 **“Income beneficiary.”** The definitions of income beneficiary (Section 102(5))  
12 and income interest (Section 102(6)) cover both mandatory and discretionary  
13 beneficiaries and interests. There are no definitions for “discretionary income  
14 beneficiary” or “discretionary income interest” because those terms are not used in the  
15 Act.

16 **Inventory value.** There is no definition for inventory value in this Act because  
17 the provisions in which that term was used in the 1962 Act have either been eliminated  
18 (in the case of the underproductive property provision) or changed in a way that  
19 eliminates the need for the term (in the case of bonds and other money obligations,  
20 property subject to depletion, and the method for determining entitlement to income  
21 distributed from a probate estate).

22 **“Net income.”** The reference to “transfers under this Act to or from income”  
23 means transfers made under Sections 104(a), 412(b), 502(b), 503(b), 504(a), and 506.

24 **“Terms of a trust.”** This term was chosen in preference to “terms of the trust  
25 instrument” (the phrase used in the 1962 Act) to make it clear that the Act applies to oral  
26 trusts as well as those whose terms are expressed in written documents. The definition is  
27 based on the Restatement (Second) of Trusts § 4 (1959) and the Restatement (Third) of  
28 Trusts § 4 (Tent. Draft No. 1, 1996). Constructional preferences or rules would also  
29 apply, if necessary, to determine the terms of the trust.

## 30 **SECTION 103. FIDUCIARY DUTIES; GENERAL PRINCIPLES.**

31 (a) In allocating receipts and disbursements to or between principal and income,  
32 and with respect to any matter within the scope of [Articles] 2 and 3, a fiduciary:

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

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

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

4 (4) shall add a receipt or charge a disbursement to principal to the extent that  
5 the terms of the trust and this [Act] do not provide a rule for allocating the receipt or  
6 disbursement to or between principal and income.

7 (b) In exercising the power to adjust under Section 104(a) or a discretionary  
8 power of administration regarding a matter within the scope of this [Act], whether  
9 granted by the terms of a trust, a will, or this [Act], a fiduciary shall administer a trust or  
10 estate impartially, based on what is fair and reasonable to all of the beneficiaries, except  
11 to the extent that the terms of the trust or the will clearly manifest an intention that the  
12 fiduciary shall or may favor one or more of the beneficiaries. A determination in  
13 accordance with this [Act] is presumed to be fair and reasonable to all of the  
14 beneficiaries.

#### 15 **Comment**

16 **Prior Act.** The rule in Section 2(a) of the 1962 Act is restated in Section 103(a),  
17 without changing its substance, to emphasize that the Act contains only default rules and  
18 that provisions in the terms of the trust are paramount. However, Section 2(a) of the 1962  
19 Act applies only to the allocation of receipts and disbursements to or between principal  
20 and income. In this Act, the first sentence of Section 103(a) states that it also applies to  
21 matters within the scope of Articles 2 and 3. Section 103(a)(2) incorporates the rule in  
22 Section 2(b) of the 1962 Act that a discretionary allocation made by the trustee that is  
23 contrary to a rule in the Act should not give rise to an inference of imprudence or  
24 partiality by the trustee.

25 The Act deletes the language that appears at the end of 1962 Act Section 2(a)(3)  
26 – “and in view of the manner in which men of ordinary prudence, discretion and  
27 judgment would act in the management of their affairs” – because persons of ordinary  
28 prudence, discretion and judgment, acting in the management of their own affairs do not  
29 normally think in terms of the interests of successive beneficiaries. If there is an analogy  
30 to an individual’s decision-making process, it is probably the individual’s decision to  
31 spend or to save, but this is not a useful guideline for trust administration. No case has  
32 been found in which a court has relied on the “prudent man” rule of the 1962 Act.

33 **Fiduciary discretion.** The general rule is that if a discretionary power is  
34 conferred upon a trustee, the exercise of that power is not subject to control by a court  
35 except to prevent an abuse of discretion. Restatement (Second) of Trusts § 187. The  
36 situations in which a court will control the exercise of a trustee’s discretion are discussed  
37 in the comments to § 187. See also *id.* § 233 Comment *p.*

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

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

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

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

#### 34          **SECTION 104. TRUSTEE'S POWER TO ADJUST.**

35          (a) A trustee may adjust between principal and income to the extent the trustee  
36          considers necessary if the trustee invests and manages trust assets as a prudent investor,  
37          the terms of the trust describe the amount that may or must be distributed to a beneficiary  
38          by referring to the trust's income, and the trustee determines, after applying the rules in  
39          Section 103(a), that the trustee is unable to comply with Section 103(b).

40          (b) In deciding whether and to what extent to exercise the power conferred by  
41          subsection (a), a trustee shall consider all factors relevant to the trust and its beneficiaries,  
42          including the following factors to the extent they are relevant:

- 43                  (1) the nature, purpose, and expected duration of the trust;
- 44                  (2) the intent of the settlor;
- 45                  (3) the identity and circumstances of the beneficiaries;

1           (4) the needs for liquidity, regularity of income, and preservation and  
2 appreciation of capital;

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

7           (6) the net amount allocated to income under the other sections of this [Act]  
8 and the increase or decrease in the value of the principal assets, which the trustee may  
9 estimate as to assets for which market values are not readily available;

10          (7) whether and to what extent the terms of the trust give the trustee the power  
11 to invade principal or accumulate income or prohibit the trustee from invading principal  
12 or accumulating income, and the extent to which the trustee has exercised a power from  
13 time to time to invade principal or accumulate income;

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

16          (9) the anticipated tax consequences of an adjustment.

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

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

22           (2) that reduces the actuarial value of the income interest in a trust to which a  
23 person transfers property with the intent to qualify for a gift tax exclusion;

24           (3) that changes the amount payable to a beneficiary as a fixed annuity or a  
25 fixed fraction of the value of the trust assets;

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

28           (5) if possessing or exercising the power to make an adjustment causes an  
29 individual to be treated as the owner of all or part of the trust for income tax purposes,  
30 and the individual would not be treated as the owner if the trustee did not possess the  
31 power to make an adjustment;

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

1 (7) if the trustee is a beneficiary of the trust; or

2 (8) if the trustee is not a beneficiary, but the adjustment would benefit the  
3 trustee directly or indirectly.

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

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

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

## 20 **Comment**

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

33 Section 104 does not empower a trustee to increase or decrease the degree of  
34 beneficial enjoyment to which a beneficiary is entitled under the terms of the trust; rather,  
35 it authorizes the trustee to make adjustments between principal and income that may be  
36 necessary if the income component of a portfolio's total return is too small or too large  
37 because of investment decisions made by the trustee under the prudent investor rule. The  
38 paramount consideration in applying Section 104(a) is the requirement in Section 103(b)  
39 that "a fiduciary must administer a trust or estate impartially, based on what is fair and  
40 reasonable to all of the beneficiaries, except to the extent that the terms of the trust or the  
41 will clearly manifest an intention that the fiduciary shall or may favor one or more of the  
42 beneficiaries." The power to adjust is subject to control by the court to prevent an abuse

1 of discretion. Restatement (Second) of Trusts § 187 (1959). See also id. §§ 183, 232, 233,  
2 Comment *p* (1959).

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

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

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

34 To meet the third condition, the trustee must first meet the requirements of  
35 Section 103(a), i.e., she must apply the terms of the trust, decide whether to exercise the  
36 discretionary powers given to the trustee under the terms of the trust, and must apply the  
37 provisions of the Act if the terms of the trust do not contain a different provision or give  
38 the trustee discretion. Second, the trustee must determine the extent to which the terms of  
39 the trust clearly manifest an intention by the settlor that the trustee may or must favor one  
40 or more of the beneficiaries. To the extent that the terms of the trust do not require  
41 partiality, the trustee must conclude that she is unable to comply with the duty to  
42 administer the trust impartially. To the extent that the terms of the trust do require or  
43 permit the trustee to favor the income beneficiary or the remainder beneficiary, the  
44 trustee must conclude that she is unable to achieve the degree of partiality required or  
45 permitted. If the trustee comes to either conclusion – that she is unable to administer the  
46 trust impartially or that she is unable to achieve the degree of partiality required or  
47 permitted – she may exercise the power to adjust under Section 104(a).

48 **Impartiality and productivity of income.** The duty of impartiality between  
49 income and remainder beneficiaries is linked to the trustee's duty to make the portfolio  
50 productive of trust accounting income whenever the distribution requirements are  
51 expressed in terms of distributing the trust's "income." The 1962 Act implies that the  
52 duty to produce income applies on an asset by asset basis because the right of an income  
53 beneficiary to receive "delayed income" from the sale proceeds of underproductive  
54 property under Section 12 of that Act arises if "any part of principal ... has not produced

1 an average net income of a least 1% per year of its inventory value for more than a year  
2 ... ." Under the prudent investor rule, "[t]o whatever extent a requirement of income  
3 productivity exists, ... the requirement applies not investment by investment but to the  
4 portfolio as a whole." Restatement of Trusts 3d: Prudent Investor Rule § 227, Comment *i*,  
5 at 34. The power to adjust under Section 104(a) is also to be exercised by considering net  
6 income from the portfolio as a whole and not investment by investment. Section 413(b)  
7 of this Act eliminates the underproductive property rule in all cases other than trusts for  
8 which a marital deduction is allowed; the rule applies to a marital deduction trust if the  
9 trust's assets "consist substantially of property that does not provide the spouse with  
10 sufficient income from or use of the trust assets ..." – in other words, the section applies  
11 by reference to the portfolio as a whole.

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

17 For a discussion of investment considerations involving specific investments and  
18 techniques under the prudent investor rule, see Restatement of Trusts 3d: Prudent  
19 Investor Rule § 227, Comments *k-p*.

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

37 **Assets received from the settlor.** Section 3 of the Uniform Prudent Investor Act  
38 provides that "[a] trustee shall diversify the investments of the trust unless the trustee  
39 reasonably determines that, because of special circumstances, the purposes of the trust are  
40 better served without diversifying." The special circumstances may include the wish to  
41 retain a family business, the benefit derived from deferring liquidation of the asset in  
42 order to defer payment of income taxes, or the anticipated capital appreciation from  
43 retaining an asset such as undeveloped real estate for a long period. To the extent the  
44 trustee retains assets received from the settlor because of special circumstances that  
45 overcome the duty to diversify, the trustee may take these circumstances into account in  
46 determining whether and to what extent the power to adjust should be exercised to  
47 change the results produced by other provisions of this Act that apply to the retained  
48 assets. See Section 104(b)(5); Uniform Prudent Investor Act § 3, Comment, 7B U.L.A.  
49 18, at 25-26 (Supp. 1997); Restatement of Trusts 3d: Prudent Investor Rule § 229 and  
50 Comments *a-e*.

51 **Limitations on the power to adjust.** The purpose of subsections (c)(1) through  
52 (4) is to preserve tax benefits that may have been an important purpose for creating the  
53 trust. Subsections (c)(5), (6), and (8) deny the power to adjust in the circumstances  
54 described in those subsections in order to prevent adverse tax consequences, and

1 subsection (c)(7) denies the power to adjust to any beneficiary, whether or not possession  
2 of the power may have adverse tax consequences.

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

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

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

28 **Release of the power to adjust.** Section 104(e) permits a trustee to release all or  
29 part of the power to adjust in circumstances in which the possession or exercise of the  
30 power might deprive the trust of a tax benefit or impose a tax burden. For example, if  
31 possessing the power would diminish the actuarial value of the income interest in a trust  
32 for which the income beneficiary’s estate may be eligible to claim a credit for property  
33 previously taxed if the beneficiary dies within ten years after the death of the person  
34 creating the trust, the trustee is permitted under subsection (e) to release just the power to  
35 adjust from income to principal.

36 **Trust terms that limit a power to adjust.** Section 104(f) applies to trust  
37 provisions that limit a trustee’s power to adjust. Since the power is intended to enable  
38 trustees to employ the prudent investor rule without being constrained by traditional  
39 principal and income rules, an instrument executed before the adoption of this Act whose  
40 terms describe the amount that may or must be distributed to a beneficiary by referring to  
41 the trust’s income or that prohibit the invasion of principal or that prohibit equitable  
42 adjustments in general should not be construed as forbidding the use of the power to  
43 adjust under Section 104(a) if the need for adjustment arises because the trustee is  
44 operating under the prudent investor rule. Instruments containing such provisions that are  
45 executed after the adoption of this Act should specifically refer to the power to adjust if  
46 the settlor intends to forbid its use. See generally, Joel C. Dobris, Limits on the Doctrine  
47 of Equitable Adjustment in Sophisticated Postmortem Tax Planning, 66 Iowa L. Rev. 273  
48 (1981).

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

50 **Example (1)** – T is the successor trustee of a trust that provides income to A for  
51 life, remainder to B. T has received from the prior trustee a portfolio of financial assets  
52 invested 20% in stocks and 80% in bonds. Following the prudent investor rule, T  
53 determines that a strategy of investing the portfolio 50% in stocks and 50% in bonds has  
54 risk and return objectives that are reasonably suited to the trust, but T also determines that

1 adopting this approach will cause the trust to receive a smaller amount of dividend and  
2 interest income. After considering the factors in Section 104(b), T may transfer cash from  
3 principal to income to the extent T considers it necessary to increase the amount  
4 distributed to the income beneficiary.

5 **Example (2)** – T is the trustee of a trust that requires the income to be paid to the  
6 settlor’s son C for life, remainder to C’s daughter D. In a period of very high inflation, T  
7 purchases bonds that pay double-digit interest and determines that a portion of the  
8 interest, which is allocated to income under Section 406 of this Act, is a return of capital.  
9 In consideration of the loss of value of principal due to inflation and other factors that T  
10 considers relevant, T may transfer part of the interest to principal.

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

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

41 **Example (5)** – T is the trustee of a trust for the settlor’s child. The trust owns a  
42 diversified portfolio of marketable financial assets with a value of \$600,000, and is also  
43 the sole beneficiary of the settlor’s IRA, which holds a diversified portfolio of marketable  
44 financial assets with a value of \$900,000. The trust receives a distribution from the IRA  
45 that is the minimum amount required to be distributed under the Internal Revenue Code,  
46 and T allocates 10% of the distribution to income under Section 409(c) of this Act. The  
47 total return on the IRA’s assets exceeds the amount distributed to the trust, and the value  
48 of the IRA at the end of the year is more than its value at the beginning of the year.  
49 Relevant factors that T may consider in determining whether to exercise the power to  
50 adjust and the extent to which an adjustment should be made to comply with Section  
51 103(b) include the total return from all of the trust’s assets, those owned directly as well  
52 as its interest in the IRA, the extent to which the trust will be subject to income tax on the  
53 portion of the IRA distribution that is allocated to principal, and the extent to which the

1 income beneficiary will be subject to income tax on the amount that T distributes to the  
2 income beneficiary.

3 **Example (6)** – T is the trustee of a trust whose portfolio includes a large parcel of  
4 undeveloped real estate. T pays real property taxes on the undeveloped parcel from  
5 income each year pursuant to Section 501(3). After considering the return from the trust’s  
6 portfolio as a whole and other relevant factors described in Section 104(b), T may  
7 exercise the power to adjust under Section 104(a) to transfer cash from principal to  
8 income in order to distribute to the income beneficiary an amount that T considers  
9 necessary to comply with Section 103(b).

10 **Example (7)** – T is the trustee of a trust whose portfolio includes an interest in a  
11 mutual fund that is sponsored by T. As the manager of the mutual fund, T charges the  
12 fund a management fee that reduces the amount available to distribute to the trust by  
13 \$2,000. If the fee had been paid directly by the trust, one-half of the fee would have been  
14 paid from income under Section 501(1) and the other one-half would have been paid  
15 from principal under Section 502(a)(1). After considering the total return from the  
16 portfolio as a whole and other relevant factors described in Section 104(b), T may  
17 exercise its power to adjust under Section 104(a) by transferring \$1,000, or half of the  
18 trust’s proportionate share of the fee, from principal to income.

## 19 [ARTICLE] 2

### 20 DECEDENT’S ESTATE OR TERMINATING INCOME INTEREST

#### 21 SECTION 201. DETERMINATION AND DISTRIBUTION OF NET INCOME.

22 After a decedent dies, in the case of an estate, or after an income interest in a trust ends,  
23 the following rules apply:

24 (1) A fiduciary of an estate or of a terminating income interest shall determine the  
25 amount of net income and net principal receipts received from property specifically given  
26 to a beneficiary under the rules in [Articles] 3 through 5 which apply to trustees and the  
27 rules in paragraph (5). The fiduciary shall distribute the net income and net principal  
28 receipts to the beneficiary who is to receive the specific property.

29 (2) A fiduciary shall determine the remaining net income of a decedent’s estate or  
30 a terminating income interest under the rules in [Articles] 3 through 5 which apply to  
31 trustees and by:

32 (A) including in net income all income from property used to discharge  
33 liabilities;

34 (B) paying from income or principal, in the fiduciary’s discretion, fees of  
35 attorneys, accountants, and fiduciaries; court costs and other expenses of administration;  
36 and interest on death taxes, but the fiduciary may pay those expenses from income of  
37 property passing to a trust for which the fiduciary claims an estate tax marital or  
38 charitable deduction only to the extent that the payment of those expenses from income  
39 will not cause the reduction or loss of the deduction; and

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

6 (3) A fiduciary shall distribute to a beneficiary who receives a pecuniary amount  
7 outright the interest or any other amount provided by the will, the terms of the trust, or  
8 applicable law from net income determined under paragraph (2) or from principal to the  
9 extent that net income is insufficient. If a beneficiary is to receive a pecuniary amount  
10 outright from a trust after an income interest ends and no interest or other amount is  
11 provided for by the terms of the trust or applicable law, the fiduciary shall distribute the  
12 interest or other amount to which the beneficiary would be entitled under applicable law  
13 if the pecuniary amount were required to be paid under a will.

14 (4) A fiduciary shall distribute the net income remaining after distributions  
15 required by paragraph (3) in the manner described in Section 202 to all other  
16 beneficiaries, including a beneficiary who receives a pecuniary amount in trust, even if  
17 the beneficiary holds an unqualified power to withdraw assets from the trust or other  
18 presently exercisable general power of appointment over the trust.

19 (5) A fiduciary may not reduce principal or income receipts from property  
20 described in paragraph (1) because of a payment described in Section 501 or 502 to the  
21 extent that the will, the terms of the trust, or applicable law requires the fiduciary to make  
22 the payment from assets other than the property or to the extent that the fiduciary  
23 recovers or expects to recover the payment from a third party. The net income and  
24 principal receipts from the property are determined by including all of the amounts the  
25 fiduciary receives or pays with respect to the property, whether those amounts accrued or  
26 became due before, on, or after the date of a decedent's death or an income interest's  
27 terminating event, and by making a reasonable provision for amounts that the fiduciary  
28 believes the estate or terminating income interest may become obligated to pay after the  
29 property is distributed.

### **Comment**

30  
31 **Terminating income interests and successive income interests.** A trust that  
32 provides for a single income beneficiary and an outright distribution of the remainder  
33 ends when the income interest ends. A more complex trust may have a number of income  
34 interests, either concurrent or successive, and the trust will not necessarily end when one  
35 of the income interests ends. For that reason, the Act speaks in terms of income interests  
36 ending and beginning rather than trusts ending and beginning. When an income interest  
37 in a trust ends, the trustee's powers continue during the winding up period required to  
38 complete its administration. A terminating income interest is one that has ended but  
39 whose administration is not complete.

1           If two or more people are given the right to receive specified percentages or  
2 fractions of the income from a trust concurrently and one of the concurrent interests ends,  
3 e.g., when a beneficiary dies, the beneficiary's income interest ends but the trust does not.  
4 Similarly, when a trust with only one income beneficiary ends upon the beneficiary's  
5 death, the trust instrument may provide that part or all of the trust assets shall continue in  
6 trust for another income beneficiary. While it is common to think and speak of this (and  
7 even to characterize it in a trust instrument) as a "new" trust, it is a continuation of the  
8 original trust for a remainder beneficiary who has an income interest in the trust assets  
9 instead of the right to receive them outright. For purposes of this Act, this is a successive  
10 income interest in the same trust. The fact that a trust may or may not end when an  
11 income interest ends is not significant for purposes of this Act.

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

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

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

33           **Administration expenses and interest on death taxes.** Under Section 201(2)(B)  
34 a fiduciary may pay administration expenses and interest on death taxes from either  
35 income or principal. An advantage of permitting the fiduciary to choose the source of the  
36 payment is that, if the fiduciary's decision is consistent with the decision to deduct these  
37 expenses for income tax purposes or estate tax purposes, it eliminates the need to adjust  
38 between principal and income that may arise when, for example, an expense that is paid  
39 from principal is deducted for income tax purposes or an expense that is paid from  
40 income is deducted for estate tax purposes.

41           The United States Supreme Court has considered the question of whether an  
42 estate tax marital deduction or charitable deduction should be reduced when  
43 administration expenses are paid from income produced by property passing in trust for a  
44 surviving spouse or for charity and deducted for income tax purposes. The Court rejected  
45 the IRS position that administration expenses properly paid from income under the terms  
46 of the trust or state law must reduce the amount of a marital or charitable transfer, and  
47 held that the value of the transferred property is not reduced for estate tax purposes unless  
48 the administration expenses are material in light of the income the trust corpus could have  
49 been expected to generate. *Commissioner v. Estate of Otis C. Hubert*, 117 S.Ct. 1124  
50 (1997). The provision in Section 201(2)(B) permits a fiduciary to pay and deduct  
51 administration expenses from income only to the extent that it will not cause the  
52 reduction or loss of an estate tax marital or charitable contributions deduction, which  
53 means that the limit on the amount payable from income will be established eventually by  
54 Treasury Regulations.

1           **Interest on estate taxes.** The IRS agrees that interest on estate and inheritance  
2 taxes may be deducted for income tax purposes without having to reduce the estate tax  
3 deduction for amounts passing to a charity or surviving spouse, whether the interest is  
4 paid from principal or income. Rev. Rul. 93-48, 93-2 C.B. 270. For estates of persons  
5 who died before 1998, a fiduciary may not want to deduct for income tax purposes  
6 interest on estate tax that is deferred under Section 6166 or 6163 because deducting that  
7 interest for estate tax purposes may produce more beneficial results, especially if the  
8 estate has little or no income or the income tax bracket is significantly lower than the  
9 estate tax bracket. For estates of persons who die after 1997, no estate tax or income tax  
10 deduction will be allowed for interest paid on estate tax that is deferred under Section  
11 6166. However, interest on estate tax deferred under Section 6163 will continue to be  
12 deductible for both purposes, and interest on estate tax deficiencies will continue to be  
13 deductible for estate tax purposes if an election under Section 6166 is not in effect.

14           Under the 1962 Act, Section 13(c)(5) charges interest on estate and inheritance  
15 taxes to principal. The 1931 Act has no provision. Section 501(3) of this Act provides  
16 that, except to the extent provided in Section 201(2)(B) or (C), all interest must be paid  
17 from income.

## 18           **SECTION 202. DISTRIBUTION TO RESIDUARY AND REMAINDER** 19 **BENEFICIARIES.**

20           (a) Each beneficiary described in Section 201(4) is entitled to receive a portion of  
21 the net income equal to the beneficiary's fractional interest in undistributed principal  
22 assets, using values as of the distribution date. If a fiduciary makes more than one  
23 distribution of assets to beneficiaries to whom this section applies, each beneficiary,  
24 including one who does not receive part of the distribution, is entitled, as of each  
25 distribution date, to the net income the fiduciary has received after the date of death or  
26 terminating event or earlier distribution date but has not distributed as of the current  
27 distribution date.

28           (b) In determining a beneficiary's share of net income, the following rules apply:

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

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

36           (3) The beneficiary's fractional interest in the undistributed principal assets  
37 must be calculated on the basis of the aggregate value of those assets as of the  
38 distribution date without reducing the value by any unpaid principal obligation.

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

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

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

#### **Comment**

**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).

### **[ARTICLE] 3**

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

### **SECTION 301. 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

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

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

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

7 **Comment**

8 **Period during which there is no beneficiary.** The purpose of the second part of  
9 subsection (d) is to provide that, at the end of a period during which there is no  
10 beneficiary to whom a trustee may distribute income, the trustee must apply the same  
11 apportionment rules that apply when a mandatory income interest ends. This provision  
12 would apply, for example, if a settlor creates a trust for grandchildren before any  
13 grandchildren are born. When the first grandchild is born, the period preceding the date  
14 of birth is treated as having ended, followed by a successive income interest, and the  
15 apportionment rules in Sections 302 and 303 apply accordingly if the terms of the trust do  
16 not contain different provisions.

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

19 (a) A trustee shall allocate an income receipt or disbursement other than one to  
20 which Section 201(1) applies to principal if its due date occurs before a decedent dies in  
21 the case of an estate or before an income interest begins in the case of a trust or  
22 successive income interest.

23 (b) A trustee shall allocate an income receipt or disbursement to income if its due  
24 date occurs on or after the date on which a decedent dies or an income interest begins and  
25 it is a periodic due date. An income receipt or disbursement must be treated as accruing  
26 from day to day if its due date is not periodic or it has no due date. The portion of the  
27 receipt or disbursement accruing before the date on which a decedent dies or an income  
28 interest begins must be allocated to principal and the balance must be allocated to  
29 income.

30 (c) An item of income or an obligation is due on the date the payer is required to  
31 make a payment. If a payment date is not stated, there is no due date for the purposes of  
32 this [Act]. Distributions to shareholders or other owners from an entity to which Section  
33 401 applies are deemed to be due on the date fixed by the entity for determining who is  
34 entitled to receive the distribution or, if no date is fixed, on the declaration date for the  
35 distribution. A due date is periodic for receipts or disbursements that must be paid at  
36 regular intervals under a lease or an obligation to pay interest or if an entity customarily  
37 makes distributions at regular intervals.

**Comment**

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

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

**Periodic payments.** Under Section 302, a periodic payment is principal if it is due but unpaid before a decedent dies or before an asset becomes subject to a trust, but the next payment is allocated entirely to income and is not apportioned. Thus, periodic receipts such as rents, dividends, interest, and annuities, and disbursements such as the interest portion of a mortgage payment, are not apportioned. This is the original common law rule. Edwin A. Howes, Jr., *The American Law Relating to Income and Principal* 70 (1905). In trusts in which a surviving spouse is dependent upon a regular flow of cash from the decedent’s securities portfolio, this rule will help to maintain payments to the spouse at the same level as before the settlor’s death. Under the 1962 Act, the pre-death portion of the first periodic payment due after death is apportioned to principal in the case of a testamentary trust or securities bequeathed by will to an inter vivos trust.

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

**SECTION 303. APPORTIONMENT WHEN INCOME INTEREST ENDS.**

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

(b) When a mandatory income interest ends, the trustee shall pay to a mandatory income beneficiary who survives that date, or the estate of a deceased mandatory income beneficiary whose death causes the interest to end, the beneficiary’s share of the undistributed income that is not disposed of under the terms of the trust unless the

1 beneficiary has an unqualified power to revoke more than five percent of the trust  
2 immediately before the income interest ends. In the latter case, the undistributed income  
3 from the portion of the trust that may be revoked must be added to principal.

4 (c) When a trustee's obligation to pay a fixed annuity or a fixed fraction of the  
5 value of the trust's assets ends, the trustee shall prorate the final payment if and to the  
6 extent required by applicable law to accomplish a purpose of the trust or its settlor  
7 relating to income, gift, estate, or other tax requirements.

### 8 **Comment**

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

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

24 **Example – accrued periodic payments.** The rules in Section 302 and Section  
25 303 work in the following manner: Assume that a periodic payment of rent that is due on  
26 July 20 has not been paid when an income interest ends on July 30; the successive  
27 income interest begins on July 31, and the rent payment that was due on July 20 is paid  
28 on August 3. Under Section 302(a), the July 20 payment is added to the principal of the  
29 successive income interest when received. Under Section 302(b), the entire periodic  
30 payment of rent that is due on August 20 is income when received by the successive  
31 income interest. Under Section 303, neither the income beneficiary of the terminated  
32 income interest nor the beneficiary's estate is entitled to any part of either the July 20 or  
33 the August 20 payments because neither one was received before the income interest  
34 ended on July 30. The same principles apply to expenses of the trust.

35 **Beneficiary with an unqualified power to revoke.** The requirement in  
36 subsection (b) to pay undistributed income to a mandatory income beneficiary or her  
37 estate does not apply to the extent the beneficiary has an unqualified power to revoke  
38 more than five percent of the trust immediately before the income interest ends. Without  
39 this exception, subsection (b) would apply to a revocable living trust whose settlor is the  
40 mandatory income beneficiary during her lifetime, even if her will provides that all of the  
41 assets in the probate estate are to be distributed to the trust.

42 If a trust permits the beneficiary to withdraw all or a part of the trust principal  
43 after attaining a specified age and the beneficiary attains that age but fails to withdraw all  
44 of the principal that she is permitted to withdraw, a trustee is not required to pay her or  
45 her estate the undistributed income attributable to the portion of the principal that she left  
46 in the trust. The assumption underlying this rule is that the beneficiary has either  
47 provided for the disposition of the trust assets (including the undistributed income) by  
48 exercising a power of appointment that she has been given or has not withdrawn the  
49 assets because she is willing to have the principal and undistributed income be distributed

1 under the terms of the trust. If the beneficiary has the power to withdraw 25% of the trust  
2 principal, the trustee must pay to her or her estate the undistributed income from the 75%  
3 that she cannot withdraw.

4 **[ARTICLE] 4**

5 **ALLOCATION OF RECEIPTS DURING ADMINISTRATION OF TRUST**

6 **[PART 1**

7 **RECEIPTS FROM ENTITIES]**

8 **SECTION 401. CHARACTER OF RECEIPTS.**

9 (a) In this section, “entity” means a corporation, partnership, limited liability  
10 company, regulated investment company, real estate investment trust, common trust fund,  
11 or any other organization in which a trustee has an interest other than a trust or estate to  
12 which Section 402 applies, a business or activity to which Section 403 applies, or an  
13 asset-backed security to which Section 415 applies.

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

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

17 (1) property other than money;

18 (2) money received in one distribution or a series of related distributions in  
19 exchange for part or all of a trust’s interest in the entity;

20 (3) money received in total or partial liquidation of the entity; and

21 (4) money received from an entity that is a regulated investment company or a  
22 real estate investment trust if the money distributed is a capital gain dividend for federal  
23 income tax purposes.

24 (d) Money is received in partial liquidation:

25 (1) to the extent that the entity, at or near the time of a distribution, indicates  
26 that it is a distribution in partial liquidation; or

27 (2) if the total amount of money and property received in a distribution or  
28 series of related distributions is greater than 20 percent of the entity’s gross assets, as  
29 shown by the entity’s year-end financial statements immediately preceding the initial  
30 receipt.

31 (e) Money is not received in partial liquidation, nor may it be taken into account  
32 under subsection (d)(2), to the extent that it does not exceed the amount of income tax  
33 that a trustee or beneficiary must pay on taxable income of the entity that distributes the  
34 money.

(f) A trustee may rely upon a statement made by an entity about the source or character of a distribution if the statement is made at or near the time of distribution by the entity's board of directors or other person or group of persons authorized to exercise powers to pay money or transfer property comparable to those of a corporation's board of directors.

### Comment

**Entities to which Section 401 applies.** The reference to partnerships in Section 401(a) is intended to include all forms of partnerships, including limited partnerships, limited liability partnerships, and variants that have slightly different names and characteristics from State to State. The section does not apply, however, to receipts from an interest in property that a trust owns as a tenant in common with one or more co-owners, nor would it apply to an interest in a joint venture if, under applicable law, the trust's interest is regarded as that of a tenant in common.

**Capital gain dividends.** Under the Internal Revenue Code and the Income Tax Regulations, a "capital gain dividend" from a 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 short-term capital loss. As a result, a capital gain dividend does not include any net short-term capital gain, and cash received by a trust because of a net short-term capital gain is income under this Act.

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

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

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

**Other large distributions.** A cash distribution may be quite large (for example, more than 10% but not more than 20% of the entity's gross assets) and have characteristics that suggest it should be treated as principal rather than income. For example, an entity may have received cash from a source other than the conduct of its normal business operations because it sold an investment asset; or because it sold a business asset other than one held for sale to customers in the normal course of its business and did not replace it; or it borrowed a large sum of money and secured the repayment of the loan with a substantial asset; or a principal source of its cash was from assets such as mineral interests, 90% of which would have been allocated to principal if

1 the trust had owned the assets directly. In such a case the trustee, after considering the  
2 total return from the portfolio as a whole and the income component of that return, may  
3 decide to exercise the power under Section 104(a) to make an adjustment between  
4 income and principal, subject to the limitations in Section 104(c).

5 **SECTION 402. DISTRIBUTION FROM TRUST OR ESTATE.** A trustee shall  
6 allocate to income an amount received as a distribution of income from a trust or an  
7 estate in which the trust has an interest other than a purchased interest, and shall allocate  
8 to principal an amount received as a distribution of principal from such a trust or estate. If  
9 a trustee purchases an interest in a trust that is an investment entity, or a decedent or  
10 donor transfers an interest in such a trust to a trustee, Section 401 or 415 applies to a  
11 receipt from the trust.

12 **Comment**

13 **Terms of the distributing trust or estate.** Under Section 103(a), a trustee is to  
14 allocate receipts in accordance with the terms of the recipient trust or, if there is no  
15 provision, in accordance with this Act. However, in determining whether a distribution  
16 from another trust or an estate is income or principal, the trustee should also determine  
17 what the terms of the distributing trust or estate say about the distribution – for example,  
18 whether they direct that the distribution, even though made from the income of the  
19 distributing trust or estate, is to be added to principal of the recipient trust. Such a  
20 provision should override the terms of this Act, but if the terms of the recipient trust  
21 contain a provision requiring such a distribution to be allocated to income, the trustee  
22 may have to obtain a judicial resolution of the conflict between the terms of the two  
23 documents.

24 **Investment trusts.** An investment entity to which the second sentence of this  
25 section applies includes a mutual fund, a common trust fund, a business trust or other  
26 entity organized as a trust for the purpose of receiving capital contributed by investors,  
27 investing that capital, and managing investment assets, including asset-backed security  
28 arrangements to which Section 415 applies. See John H. Langbein, *The Secret Life of the*  
29 *Trust: The Trust as an Instrument of Commerce*, 107 Yale L.J. 165 (1997).

30 **SECTION 403. BUSINESS AND OTHER ACTIVITIES CONDUCTED BY**  
31 **TRUSTEE.**

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

37 (b) A trustee who accounts separately for a business or other activity may  
38 determine the extent to which its net cash receipts must be retained for working capital,  
39 the acquisition or replacement of fixed assets, and other reasonably foreseeable needs of  
40 the business or activity, and the extent to which the remaining net cash receipts are  
41 accounted for as principal or income in the trust's general accounting records. If a trustee

1 sells assets of the business or other activity, other than in the ordinary course of the  
2 business or activity, the trustee shall account for the net amount received as principal in  
3 the trust's general accounting records to the extent the trustee determines that the amount  
4 received is no longer required in the conduct of the business.

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

- 7 (1) retail, manufacturing, service, and other traditional business activities;
- 8 (2) farming;
- 9 (3) raising and selling livestock and other animals;
- 10 (4) management of rental properties;
- 11 (5) extraction of minerals and other natural resources;
- 12 (6) timber operations; and
- 13 (7) activities to which Section 414 applies.

#### 14 **Comment**

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

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

35 If a fiduciary liquidates a sole proprietorship or other activity to which Section  
36 403 applies, the proceeds would be added to principal, even though derived from the  
37 liquidation of accounts receivable, because the proceeds would no longer be needed in  
38 the conduct of the business. If the liquidation occurs during probate or during an income  
39 interest's winding up period, none of the proceeds would be income for purposes of  
40 Section 201.

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

1 and to what extent it is to be transferred to the trust's general accounts, either as income  
2 or principal.

3 [PART 2  
4 RECEIPTS NOT NORMALLY APPORTIONED]

5 **SECTION 404. PRINCIPAL RECEIPTS.** A trustee shall allocate to principal:

6 (1) to the extent not allocated to income under this [Act], assets received from a  
7 transferor during the transferor's lifetime, a decedent's estate, a trust with a terminating  
8 income interest, or a payer under a contract naming the trust or its trustee as beneficiary;

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

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

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

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

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

20 **Comment**

21 **Eminent domain awards.** Even though the award in an eminent domain  
22 proceeding may include an amount for the loss of future rent on a lease, if that amount is  
23 not separately stated the entire award is principal. The rule is the same in the 1931 and  
24 1962 Acts.

25 **SECTION 405. RENTAL PROPERTY.** To the extent that a trustee accounts for  
26 receipts from rental property pursuant to this section, the trustee shall allocate to income  
27 an amount received as rent of real or personal property, including an amount received for  
28 cancellation or renewal of a lease. An amount received as a refundable deposit, including  
29 a security deposit or a deposit that is to be applied as rent for future periods, must be  
30 added to principal and held subject to the terms of the lease and is not available for  
31 distribution to a beneficiary until the trustee's contractual obligations have been satisfied  
32 with respect to that amount.

**Comment**

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

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

**SECTION 406. OBLIGATION TO PAY MONEY.**

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

(b) A trustee shall allocate to principal an amount received from the sale, redemption, or other disposition of an 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.

(c) This section does not apply to an obligation to which Section 409, 410, 411, 412, 414, or 415 applies.

**Comment**

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

**Discount obligations.** Subsection (b) applies to all obligations acquired at a discount, including short-term obligations such as U.S. Treasury Bills, long-term obligations such as U.S. Savings Bonds, zero-coupon bonds, and discount bonds that pay interest during part, but not all, of the period before maturity. Under subsection (b), the entire increase in value of these obligations is principal when the trustee receives the proceeds from the disposition unless the obligation, when acquired, has a maturity of less than one year. In order to have one rule that applies to all discount obligations, the Act eliminates the provision in the 1962 Act for the payment from principal of an amount equal to the increase in the value of U.S. Series E bonds. The provision for bonds that

1 mature within one year after acquisition by the trustee is derived from the Illinois act. 760  
2 ILCS 15/8 (1996).

3 Subsection (b) also applies to inflation-indexed bonds – any increase in principal  
4 due to inflation after issuance is principal upon redemption if the bond matures more than  
5 one year after the trustee acquires it; if it matures within one year, all of the increase,  
6 including any attributable to an inflation adjustment, is income.

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

#### 11 **SECTION 407. INSURANCE POLICIES AND SIMILAR CONTRACTS.**

12 (a) Except as otherwise provided in subsection (b), a trustee shall allocate to  
13 principal the proceeds of a life insurance policy or other contract in which the trust or its  
14 trustee is named as beneficiary, including a contract that insures the trust or its trustee  
15 against loss for damage to, destruction of, or loss of title to a trust asset. The trustee shall  
16 allocate dividends on an insurance policy to income if the premiums on the policy are  
17 paid from income, and to principal if the premiums are paid from principal.

18 (b) A trustee shall allocate to income proceeds of a contract that insures the  
19 trustee against loss of occupancy or other use by an income beneficiary, loss of income,  
20 or, subject to Section 403, loss of profits from a business.

21 (c) This section does not apply to a contract to which Section 409 applies.

#### 22 [PART 3

#### 23 RECEIPTS NORMALLY APPORTIONED]

24 **SECTION 408. INSUBSTANTIAL ALLOCATIONS NOT REQUIRED.** If a  
25 trustee determines that an allocation between principal and income required by Section  
26 409, 410, 411, 412, or 415 is insubstantial, the trustee may allocate the entire amount to  
27 principal unless one of the circumstances described in Section 104(c) applies to the  
28 allocation. This power may be exercised by a cotrustee in the circumstances described in  
29 Section 104(d) and may be released for the reasons and in the manner described in  
30 Section 104(e). An allocation is presumed to be insubstantial if:

31 (1) the amount of the allocation would increase or decrease net income in an  
32 accounting period, as determined before the allocation, by less than 10 percent; or

33 (2) the value of the asset producing the receipt for which the allocation would be  
34 made is less than 10 percent of the total value of the trust's assets at the beginning of the  
35 accounting period.

**Comment**

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.

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 net income from the assets other than the working interest is \$40,000; and the net receipts from the working interest are \$400. The trustee may allocate all of the net receipts from the working interest to principal instead of allocating 10%, or \$40, to income under Section 411. If the net receipts from the working interest are \$35,000, so that the amount allocated to income under Section 411 would be \$3,500, the trustee may decide that this amount is sufficiently significant to the income beneficiary that the allocation provided for by Section 411 should be made, even though the trustee is still permitted under Section 408 to allocate all of the net receipts to principal because the \$3,500 would increase the net income of \$40,000, as determined before making an allocation under Section 411, by less than 10%. Section 408 will also relieve a trustee from having to allocate net receipts from the sale of trees in a small woodlot between principal and income.

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

**SECTION 409. DEFERRED COMPENSATION, ANNUITIES, AND SIMILAR PAYMENTS.**

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

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

(c) If no part of a payment is characterized as interest, a dividend, or an equivalent payment, and all or part of the payment is required to be made, a trustee shall allocate to income 10 percent of the part that is required to be made during the accounting period and the balance to principal. If no part of a payment is required to be made or the payment received is the entire amount to which the trustee is entitled, the trustee shall allocate the entire payment to principal. For purposes of this subsection, a payment is not

1 “required to be made” to the extent that it is made because the trustee exercises a right of  
2 withdrawal.

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

6 (e) This section does not apply to payments to which Section 410 applies.

### 7 **Comment**

8 **Scope.** Section 409 applies to amounts received under contractual arrangements  
9 that provide for payments to a third party beneficiary as a result of services rendered or  
10 property transferred to the payer. While the right to receive such payments is a  
11 liquidating asset of the kind described in Section 410 (i.e., “an asset whose value will  
12 diminish or terminate because the asset is expected to produce receipts for a period of  
13 limited duration”), these payment rights are covered separately in Section 409 because of  
14 their special characteristics.

15 Section 409 applies to receipts from all forms of annuities and deferred  
16 compensation arrangements, whether the payment will be received by the trust in a lump  
17 sum or in installments over a period of years. It applies to bonuses that may be received  
18 over two or three years and payments that may last for much longer periods, including  
19 payments from an individual retirement account (IRA), deferred compensation plan  
20 (whether qualified or not qualified for special federal income tax treatment), and  
21 insurance renewal commissions. It applies to a retirement plan to which the settlor has  
22 made contributions, just as it applies to an annuity policy that the settlor may have  
23 purchased individually, and it applies to variable annuities, deferred annuities, annuities  
24 issued by commercial insurance companies, and “private annuities” arising from the sale  
25 of property to another individual or entity in exchange for payments that are to be made  
26 for the life of one or more individuals. The section applies whether the payments begin  
27 when the payment right becomes subject to the trust or are deferred until a future date,  
28 and it applies whether payments are made in cash or in kind, such as employer stock (in-  
29 kind payments usually will be made in a single distribution that will be allocated to  
30 principal under the second sentence of subsection (c)).

31 **The 1962 Act.** Under Section 12 of the 1962 Act, receipts from “rights to  
32 receive payments on a contract for deferred compensation” are allocated to income each  
33 year in an amount “not in excess of 5% per year” of the property’s inventory value.  
34 While “not in excess of 5%” suggests that the annual allocation may range from zero to  
35 5% of the inventory value, in practice the rule is usually treated as prescribing a 5%  
36 allocation. The inventory value is usually the present value of all the future payments,  
37 and since the inventory value is determined as of the date on which the payment right  
38 becomes subject to the trust, the inventory value, and thus the amount of the annual  
39 income allocation, depends significantly on the applicable interest rate on the decedent’s  
40 date of death. That rate may be much higher or lower than the average long-term interest  
41 rate. The amount determined under the 5% formula tends to become fixed and remain  
42 unchanged even though the amount received by the trust increases or decreases.

43 **Allocations Under Section 409(b).** Section 409(b) applies to plans whose terms  
44 characterize payments made under the plan as dividends, interest, or payments in lieu of  
45 dividends or interest. For example, some deferred compensation plans that hold debt  
46 obligations or stock of the plan’s sponsor in an account for future delivery to the person  
47 rendering the services provide for the annual payment to that person of dividends  
48 received on the stock or interest received on the debt obligations. Other plans provide that  
49 the account of the person rendering the services shall be credited with “phantom” shares

1 of stock and require an annual payment that is equivalent to the dividends that would be  
2 received on that number of shares if they were actually issued; or a plan may entitle the  
3 person rendering the services to receive a fixed dollar amount in the future and provide  
4 for the annual payment of interest on the deferred amount during the period prior to its  
5 payment. Under Section 409(b), payments of dividends, interest or payments in lieu of  
6 dividends or interest under plans of this type are allocated to income; all other payments  
7 received under these plans are allocated to principal.

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

11 **Allocations Under Section 409(c).** The focus of Section 409, for purposes of  
12 allocating payments received by a trust to or between principal and income, is on the  
13 payment right rather than on assets that may be held in a fund from which the payments  
14 are made. Thus, if an IRA holds a portfolio of marketable stocks and bonds, the amount  
15 received by the IRA as dividends and interest is not taken into account in determining the  
16 principal and income allocation except to the extent that the Internal Revenue Service  
17 may require them to be taken into account when the payment is received by a trust that  
18 qualifies for the estate tax marital deduction (a situation that is provided for in Section  
19 409(d)). An IRA is subject to federal income tax rules that require payments to begin by a  
20 particular date and be made over a specific number of years or a period measured by the  
21 lives of one or more persons. The payment right of a trust that is named as a beneficiary  
22 of an IRA is not a right to receive particular items that are paid to the IRA, but is instead  
23 the right to receive an amount determined by dividing the value of the IRA by the  
24 remaining number of years in the payment period. This payment right is similar to the  
25 right to receive a unitrust amount, which is normally expressed as an amount equal to a  
26 percentage of the value of the unitrust assets without regard to dividends or interest that  
27 may be received by the unitrust.

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

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

44 **Marital deduction requirements.** When an IRA is payable to a QTIP marital  
45 deduction trust, the IRS treats the IRA as separate terminable interest property and  
46 requires that a QTIP election be made for it. In order to qualify for QTIP treatment, an  
47 IRS ruling states that all of the IRA's income must be distributed annually to the QTIP  
48 marital deduction trust and then must be allocated to trust income for distribution to the  
49 spouse. Rev. Rul. 89-89, 1989-2 C.B. 231. If an allocation to income under this Act of  
50 10% of the required distribution from the IRA does not meet the requirement that all of  
51 the IRA's income be distributed from the trust to the spouse, the provision in subsection  
52 (d) requires the trustee to make a larger allocation to income to the extent necessary to  
53 qualify for the marital deduction. The requirement of Rev. Rul. 89-89 should also be  
54 satisfied if the IRA beneficiary designation permits the spouse to require the trustee to

1 withdraw the necessary amount from the IRA and distribute it to her, even though the  
2 spouse never actually requires the trustee to do so. If such a provision is in the  
3 beneficiary designation, a distribution under subsection (d) should not be necessary.

4 **Application of Section 104.** Section 104(a) of this Act gives a trustee who is  
5 acting under the prudent investor rule the power to adjust from principal to income if,  
6 considering the portfolio as a whole and not just receipts from deferred compensation, the  
7 trustee determines that an adjustment is necessary. See Example (5) in the Comment  
8 following Section 104.

## 9 **SECTION 410. LIQUIDATING ASSET.**

10 (a) In this section, “liquidating asset” means an asset whose value will diminish or  
11 terminate because the asset is expected to produce receipts for a period of limited  
12 duration. The term includes a leasehold, patent, copyright, royalty right, and right to  
13 receive payments during a period of more than one year under an arrangement that does  
14 not provide for the payment of interest on the unpaid balance. The term does not include  
15 a payment subject to Section 409, resources subject to Section 411, timber subject to  
16 Section 412, an activity subject to Section 414, an asset subject to Section 415, or any  
17 asset for which the trustee establishes a reserve for depreciation under Section 503.

18 (b) A trustee shall allocate to income 10 percent of the receipts from a liquidating  
19 asset and the balance to principal.

### 20 **Comment**

21 **Prior Acts.** Section 11 of the 1962 Act allocates receipts from “property subject  
22 to depletion” to income in an amount “not in excess of 5%” of the asset’s inventory  
23 value. The 1931 Act has a similar 5% rule that applies when the trustee is under a duty to  
24 change the form of the investment. The 5% rule imposes on a trust the obligation to pay a  
25 fixed annuity to the income beneficiary until the asset is exhausted. Under both the 1931  
26 and 1962 Acts the balance of each year’s receipts is added to principal. A fixed payment  
27 can produce unfair results. The remainder beneficiary receives all of the receipts from  
28 unexpected growth in the asset, e.g., if royalties on a patent or copyright increase  
29 significantly. Conversely, if the receipts diminish more rapidly than expected, most of the  
30 amount received by the trust will be allocated to income and little to principal. Moreover,  
31 if the annual payments remain the same for the life of the asset, the amount allocated to  
32 principal will usually be less than the original inventory value. For these reasons, Section  
33 410 abandons the annuity approach under the 5% rule.

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

## 38 **SECTION 411. MINERALS, WATER, AND OTHER NATURAL** 39 **RESOURCES.**

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

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

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

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

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

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

15 (c) This [Act] applies whether or not a decedent or donor was extracting minerals,  
16 water, or other natural resources before the interest became subject to the trust.

17 (d) If a trust owns an interest in minerals, water, or other natural resources on [the  
18 effective date of this [Act]], the trustee may allocate receipts from the interest as provided  
19 in this [Act] or in the manner used by the trustee before [the effective date of this [Act]].  
20 If the trust acquires an interest in minerals, water, or other natural resources after [the  
21 effective date of this [Act]], the trustee shall allocate receipts from the interest as  
22 provided in this [Act].

### 23 **Comment**

24 **Prior Acts.** The 1962 Act allocates to principal as a depletion allowance, 27-  
25 1/2% of the gross receipts, but not more than 50% of the net receipts after paying  
26 expenses. The Internal Revenue Code no longer provides for a 27-1/2% depletion  
27 allowance, although the major oil-producing States have retained the 27-1/2% provision  
28 in their principal and income acts (Texas amended its Act in 1993, but did not change the  
29 depletion provision). Section 9 of the 1931 Act allocates all of the net proceeds received  
30 as consideration for the “permanent severance of natural resources from the lands” to  
31 principal.

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

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

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

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

19       If the property is in a State other than the State where the trust is administered,  
20 the trustee must be aware that the law of the property’s situs may control this question.  
21 The outcome turns on a variety of questions: whether the terms of the trust specify that  
22 the law of a State other than the situs of the property shall govern the administration of  
23 the trust, and whether the courts will follow the terms of the trust; whether the trust’s  
24 asset is the land itself or a leasehold interest in the land (as it frequently is with oil and  
25 gas property); whether a leasehold interest or its proceeds should be classified as real  
26 property or personal property, and if as personal property, whether applicable state law  
27 treats it as a movable or an immovable for conflict of laws purposes. See 5A Austin W.  
28 Scott & William F. Fratcher, *The Law of Trusts* §§ 648, at 531, 533-534; § 657, at 600  
29 (4th ed. 1989).

## 30       **SECTION 412. TIMBER.**

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

33               (1) to income to the extent that the amount of timber removed from the land  
34 does not exceed the rate of growth of the timber during the accounting periods in which a  
35 beneficiary has a mandatory income interest;

36               (2) to principal to the extent that the amount of timber removed from the land  
37 exceeds the rate of growth of the timber or the net receipts are from the sale of standing  
38 timber;

39               (3) to or between income and principal if the net receipts are from the lease of  
40 timberland or from a contract to cut timber from land owned by a trust, by determining  
41 the amount of timber removed from the land under the lease or contract and applying the  
42 rules in paragraphs (1) and (2); or

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

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

3 (c) This [Act] applies whether or not a decedent or transferor was harvesting  
4 timber from the property before it become subject to the trust.

5 (d) If a trust owns an interest in timberland on [the effective date of this [Act]],  
6 the trustee may allocate net receipts from the sale of timber and related products as  
7 provided in this [Act] or in the manner used by the trustee before [the effective date of  
8 this [Act]]. If the trust acquires an interest in timberland after [the effective date of this  
9 [Act]], the trustee shall allocate net receipts from the sale of timber and related products  
10 as provided in this [Act].

### 11 **Comment**

12 **Scope of section.** The rules in Section 412 are intended to apply to net receipts  
13 from the sale of trees and by-products from harvesting and processing trees without  
14 regard to the kind of trees that are cut or whether the trees are cut before or after a  
15 particular number of years of growth. The rules apply to the sale of trees that are  
16 expected to produce lumber for building purposes, trees sold as pulpwood, and Christmas  
17 and other ornamental trees. Subsection (a) applies to net receipts from property owned by  
18 the trustee and property leased by the trustee. The Act is not intended to prevent a tenant  
19 in possession of the property from using wood that he cuts on the property for personal,  
20 noncommercial purposes, such as a Christmas tree, firewood, mending old fences or  
21 building new fences, or making repairs to structures on the property.

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

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

## 35 **SECTION 413. PROPERTY NOT PRODUCTIVE OF INCOME.**

36 (a) If a marital deduction is allowed for all or part of a trust whose assets consist  
37 substantially of property that does not provide the spouse with sufficient income from or  
38 use of the trust assets, and if the amounts that the trustee transfers from principal to  
39 income under Section 104 and distributes to the spouse from principal pursuant to the  
40 terms of the trust are insufficient to provide the spouse with the beneficial enjoyment  
41 required to obtain the marital deduction, the spouse may require the trustee to make  
42 property productive of income, convert property within a reasonable time, or exercise the

1 power conferred by Section 104(a). The trustee may decide which action or combination  
2 of actions to take.

3 (b) In cases not governed by subsection (a), proceeds from the sale or other  
4 disposition of an asset are principal without regard to the amount of income the asset  
5 produces during any accounting period.

### 6 **Comment**

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

22 **Duty to make property productive of income.** In order to implement the  
23 Uniform Prudent Investor Act, this Act abolishes the right to receive delayed income  
24 from the sale proceeds of an asset that produces little or no income, but it does not alter  
25 existing state law regarding the income beneficiary's right to compel the trustee to make  
26 property productive of income. As the law continues to develop in this area, the duty to  
27 make property productive of current income in a particular situation should be  
28 determined by taking into consideration the performance of the portfolio as a whole and  
29 the extent to which a trustee makes principal distributions to the income beneficiary  
30 under the terms of the trust and adjustments between principal and income under Section  
31 104 of this Act.

32 Trusts for which the value of the right to receive income is important for tax  
33 reasons may be affected by Reg. § 1.7520-3(b)(2)(v) *Example (1)*, § 20.7520-3(b)(2)(v)  
34 *Examples (1) and (2)*, and § 25.7520-3(b)(2)(v) *Examples (1) and (2)*, which provide that  
35 if the income beneficiary does not have the right to compel the trustee to make the  
36 property productive, the income interest is considered unproductive and may not be  
37 valued actuarially under those sections.

38 **Marital deduction trusts.** Subsection (a) draws on language in Reg. §  
39 20.2056(b)-5(f)(4) and (5) to enable a trust for a spouse to qualify for a marital deduction  
40 if applicable state law is unclear about the spouse's right to compel the trustee to make  
41 property productive of income. The trustee should also consider the application of  
42 Section 104 of this Act and the provisions of Restatement of Trusts 3d: Prudent Investor  
43 Rule § 240, at 186, app. § 240, at 252 (1992). Example (6) in the Comment to Section  
44 104 describes a situation involving the payment from income of carrying charges on  
45 unproductive real estate in which Section 104 may apply.

46 Once the two conditions have occurred – insufficient beneficial enjoyment from  
47 the property and the spouse's demand that the trustee take action under this section – the  
48 trustee must act; but instead of the formulaic approach of the 1962 Act, which is triggered  
49 only if the trustee sells the property, this Act permits the trustee to decide whether to  
50 make the property productive of income, convert it, transfer funds from principal to

1 income, or to take some combination of those actions. The trustee may rely on the power  
2 conferred by Section 104(a) to adjust from principal to income if the trustee decides that  
3 it is not feasible or appropriate to make the property productive of income or to convert  
4 the property. Given the purpose of Section 413, the power under Section 104(a) would be  
5 exercised to transfer principal to income and not to transfer income to principal.

6 Section 413 does not apply to a so-called “estate” trust, which will qualify for the  
7 marital deduction, even though the income may be accumulated for a term of years or for  
8 the life of the surviving spouse, if the terms of the trust require the principal and  
9 undistributed income to be paid to the surviving spouse’s estate when the spouse dies.  
10 Reg. § 20.2056(c)-2(b)(1)(iii).

#### 11 **SECTION 414. DERIVATIVES AND OPTIONS.**

12 (a) In this section, “derivative” means a contract or financial instrument or a  
13 combination of contracts and financial instruments which gives a trust the right or  
14 obligation to participate in some or all changes in the price of a tangible or intangible  
15 asset or group of assets, or changes in a rate, an index of prices or rates, or other market  
16 indicator for an asset or a group of assets.

17 (b) To the extent that a trustee does not account under Section 403 for transactions  
18 in derivatives, the trustee shall allocate to principal receipts from and disbursements  
19 made in connection with those transactions.

20 (c) If a trustee grants an option to buy property from the trust, whether or not the  
21 trust owns the property when the option is granted, grants an option that permits another  
22 person to sell property to the trust, or acquires an option to buy property for the trust or  
23 an option to sell an asset owned by the trust, and the trustee or other owner of the asset is  
24 required to deliver the asset if the option is exercised, an amount received for granting the  
25 option must be allocated to principal. An amount paid to acquire the option must be paid  
26 from principal. A gain or loss realized upon the exercise of an option, including an option  
27 granted to a settlor of the trust for services rendered, must be allocated to principal.

#### 28 **Comment**

29 **Scope and application.** It is difficult to predict how frequently and to what  
30 extent trustees will invest directly in derivative financial instruments rather than  
31 participating indirectly through investment entities that may utilize these instruments in  
32 varying degrees. If the trust participates in derivatives indirectly through an entity, an  
33 amount received from the entity will be allocated under Section 401 and not Section 414.  
34 If a trustee invests directly in derivatives to a significant extent, the expectation is that  
35 receipts and disbursements related to derivatives will be accounted for under Section 403;  
36 if a trustee chooses not to account under Section 403, Section 414(b) provides the default  
37 rule. Certain types of option transactions in which trustees may engage are dealt with in  
38 subsection (c) to distinguish those transactions from ones involving options that are  
39 embedded in derivative financial instruments.

40 **Definition of “derivative.”** “Derivative” is a difficult term to define because new  
41 derivatives are invented daily as dealers tailor their terms to achieve specific financial  
42 objectives for particular clients. Since derivatives are typically contract-based, a

1 derivative can probably be devised for almost any set of objectives if another party can be  
2 found who is willing to assume the obligations required to meet those objectives.

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

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

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

29 **Marking to market.** A gain or loss that occurs because the trustee marks  
30 securities to market or to another value during an accounting period is not a transaction in  
31 a derivative financial instrument that is income or principal under the Act – only cash  
32 receipts and disbursements, and the receipt of property in exchange for a principal asset,  
33 affect a trust’s principal and income accounts.

34 **Receipt of property other than cash.** If a trustee receives property other than  
35 cash upon the settlement of a derivatives transaction, that property would be principal  
36 under Section 404(2).

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

## 45 **SECTION 415. ASSET-BACKED SECURITIES.**

46 (a) In this section, “asset-backed security” means an asset whose value is based  
47 upon the right it gives the owner to receive distributions from the proceeds of financial  
48 assets that provide collateral for the security. The term includes an asset that gives the

owner the right to receive from the collateral financial assets only the interest or other current return or only the proceeds other than interest or current return. The term does not include an asset to which Section 401 or 409 applies.

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

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

#### Comment

**Scope of section.** Typical asset-backed securities include arrangements in which debt obligations such as real estate mortgages, credit card receivables and auto loans are acquired by an investment trust and interests in the trust are sold to investors. The source for payments to an investor is the money received from principal and interest payments on the underlying debt. An asset-backed security includes an "interest only" or a "principal only" security that permits the investor to receive only the interest payments received from the bonds, mortgages or other assets that are the collateral for the asset-backed security, or only the principal payments made on those collateral assets. An asset-backed security also includes a security that permits the investor to participate in either the capital appreciation of an underlying security or in the interest or dividend return from such a security, such as the "Primes" and "Scores" issued by Americus Trust. An asset-backed security does not include an interest in a corporation, partnership, or an investment trust described in the Comment to Section 402, whose assets consist significantly or entirely of investment assets. Receipts from an instrument that do not come within the scope of this section or any other section of the Act would be allocated entirely to principal under the rule in Section 103(a)(4), and the trustee may then consider whether and to what extent to exercise the power to adjust in Section 104, taking into account the return from the portfolio as whole and other relevant factors.

## [ARTICLE] 5

### ALLOCATION OF DISBURSEMENTS DURING ADMINISTRATION OF TRUST

**SECTION 501. DISBURSEMENTS FROM INCOME.** A trustee shall make the following disbursements from income to the extent that they are not disbursements to which Section 201(2)(B) or (C) applies:

(1) one-half of the regular compensation of the trustee and of any person providing investment advisory or custodial services to the trustee;

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

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

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

#### Comment

**Trustee fees.** The regular compensation of a trustee or the trustee's agent includes compensation based on a percentage of either principal or income or both.

**Insurance premiums.** The reference in paragraph (4) to "recurring" premiums is intended to distinguish premiums paid annually for fire insurance from premiums on title insurance, each of which covers the loss of a principal asset. Title insurance premiums would be a principal disbursement under Section 502(a)(5).

**Regularly recurring taxes.** The reference to "regularly recurring taxes assessed against principal" includes all taxes regularly imposed on real property and tangible and intangible personal property.

### SECTION 502. DISBURSEMENTS FROM PRINCIPAL.

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

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

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

(3) payments on the principal of a trust debt;

(4) expenses of a proceeding that concerns primarily principal, including a proceeding to construe the trust or to protect the trust or its property;

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

(6) estate, inheritance, and other transfer taxes, including penalties, apportioned to the trust; and

(7) disbursements related to environmental matters, including reclamation, assessing environmental conditions, remedying and removing environmental contamination, monitoring remedial activities and the release of substances, preventing future releases of substances, collecting amounts from persons liable or potentially liable

1 for the costs of those activities, penalties imposed under environmental laws or  
2 regulations and other payments made to comply with those laws or regulations, statutory  
3 or common law claims by third parties, and defending claims based on environmental  
4 matters.

5 (b) If a principal asset is encumbered with an obligation that requires income from  
6 that asset to be paid directly to the creditor, the trustee shall transfer from principal to  
7 income an amount equal to the income paid to the creditor in reduction of the principal  
8 balance of the obligation.

9 **Comment**

10 **Environmental expenses.** All environmental expenses are payable from  
11 principal, subject to the power of the trustee to transfer funds to principal from income  
12 under Section 504. However, the Drafting Committee decided that it was not necessary to  
13 broaden this provision to cover other expenditures made under compulsion of  
14 governmental authority. See generally the annotation at 43 A.L.R.4th 1012 (Duty as  
15 Between Life Tenant and Remainderman with Respect to Cost of Improvements or  
16 Repairs Made Under Compulsion of Governmental Authority).

17 Environmental expenses paid by a trust are to be paid from principal under  
18 Section 502(a)(7) on the assumption that they will usually be extraordinary in nature.  
19 Environmental expenses might be paid from income if the trustee is carrying on a  
20 business that uses or sells toxic substances, in which case environmental cleanup costs  
21 would be a normal cost of doing business and would be accounted for under Section 403.  
22 In accounting under that Section, environmental costs will be a factor in determining how  
23 much of the net receipts from the business is trust income. Paying all other environmental  
24 expenses from principal is consistent with this Act's approach regarding receipts – when  
25 a receipt is not clearly a current return on a principal asset, it should be added to principal  
26 because over time both the income and remainder beneficiaries benefit from this  
27 treatment. Here, allocating payments required by environmental laws to principal  
28 imposes the detriment of those payments over time on both the income and remainder  
29 beneficiaries.

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

35 The first part of Section 502(a)(7) is based upon the definition of an  
36 “environmental remediation trust” in Treas. Reg. § 301.7701-4(e)(as amended in 1996).  
37 This is not because the Act applies to an environmental remediation trust, but because the  
38 definition is a useful and thoroughly vetted description of the kinds of expenses that a  
39 trustee owning contaminated property might incur. Expenses incurred to comply with  
40 environmental laws include the cost of environmental consultants, administrative  
41 proceedings and burdens of every kind imposed as the result of an administrative or  
42 judicial proceeding, even though the burden is not formally characterized as a penalty.

43 **Title proceedings.** Disbursements that are made to protect a trust's property,  
44 referred to in Section 502(a)(4), include an “action to assure title” that is mentioned in  
45 Section 13(c)(2) of the 1962 Act.

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

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

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

(3) under this section if the trustee is accounting under Section 403 for the business or activity in which the asset is used.

## Comment

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

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

1 one or more accounting periods to reimburse principal or to provide a reserve for future  
2 principal disbursements.

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

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

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

10 (3) disbursements made to prepare property for rental, including tenant  
11 allowances, leasehold improvements, and broker's commissions;

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

15 (5) disbursements described in Section 502(a)(7).

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

### 19 **Comment**

20 **Prior Acts.** The sources of Section 504 are Section 13(b) of the 1962 Act, which  
21 permits a trustee to "regularize distributions," if charges against income are unusually  
22 large, by using "reserves or other reasonable means" to withhold sums from income  
23 distributions; Section 13(c)(3) of the 1962 Act, which authorizes a trustee to establish an  
24 allowance for depreciation out of income if principal is used for extraordinary repairs,  
25 capital improvements and special assessments; and Section 12(3) of the 1931 Act, which  
26 permits the trustee to spread income expenses of unusual amount "throughout a series of  
27 years." Section 504 contains a more detailed enumeration of the circumstances in which  
28 this authority may be used, and includes in subsection (b)(4) the express authority to use  
29 income to make principal payments on a mortgage if the depreciation charge against  
30 income is less than the principal payments on the mortgage.

### 31 **SECTION 505. INCOME TAXES.**

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

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

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

(1) from income to the extent that receipts from the entity are allocated to income; and

(2) from principal to the extent that:

(A) receipts from the entity are allocated to principal; and

(B) the trust's share of the entity's taxable income exceeds the total receipts described in paragraphs (1) and (2)(A).

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

### Comment

**Electing Small Business Trusts.** An Electing Small Business Trust (ESBT) is a creature created by Congress in the Small Business Job Protection Act of 1996 (P.L. 104-188). For years beginning after 1996, an ESBT may qualify as an S corporation stockholder even if the trustee does not distribute all of the trust's income annually to its beneficiaries. The portion of an ESBT that consists of the S corporation stock is treated as a separate trust for tax purposes (but not for trust accounting purposes), and the S corporation income is taxed directly to that portion of the trust even if some or all of that income is distributed to the beneficiaries.

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

## SECTION 506. ADJUSTMENTS BETWEEN PRINCIPAL AND INCOME BECAUSE OF TAXES.

(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 which arise from:

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

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

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

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

### Comment

**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).

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.

**Mandatory adjustment.** Subsection (b) provides for a mandatory adjustment from income to principal to the extent needed to preserve an estate tax marital deduction or charitable contributions deduction. It is derived from New York's EPTL § 11-1.2(A), which requires principal to be reimbursed by those who benefit when a fiduciary elects to deduct administration expenses on an income tax return instead of the estate tax return. Unlike the New York provision, subsection (b) limits a mandatory reimbursement to cases in which a marital deduction or a charitable contributions deduction is reduced by the payment of additional estate taxes because of the fiduciary's income tax election. It is intended to preserve the result reached in *Estate of Britenstool v. Commissioner*, 46 T.C. 711 (1966), in which the Tax Court held that a reimbursement required by the

predecessor of EPTL § 11-1.2(A) resulted in the estate receiving the same charitable contributions deduction it would have received if the administration expenses had been deducted for estate tax purposes instead of for income tax purposes. Because a fiduciary will elect to deduct administration expenses for income tax purposes only when the income tax reduction exceeds the estate tax reduction, the effect of this adjustment is that the principal is placed in the same position it would have occupied if the fiduciary had deducted the expenses for estate tax purposes, but the income beneficiaries receive an additional benefit. For example, if the income tax benefit from the deduction is \$30,000 and the estate tax benefit would have been \$20,000, principal will be reimbursed \$20,000 and the net benefit to the income beneficiaries will be \$10,000.

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

## [ARTICLE] 6

### MISCELLANEOUS PROVISIONS

**SECTION 601. UNIFORMITY OF APPLICATION AND CONSTRUCTION.** In applying and construing this Uniform Act, consideration must be given to the need to promote uniformity of the law with respect to its subject matter among States that enact it.

**SECTION 602. SEVERABILITY CLAUSE.** If any provision of this [Act] or its application to any person or circumstance is held invalid, the invalidity does not affect other provisions or applications of this [Act] which can be given effect without the invalid provision or application, and to this end the provisions of this [Act] are severable.

**SECTION 603. REPEAL.** The following acts and parts of acts are repealed:

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

1       **SECTION 604. EFFECTIVE DATE.** This [Act] takes effect on .....

2       **SECTION 605. APPLICATION OF [ACT] TO EXISTING TRUSTS AND**  
3 **ESTATES.** This [Act] applies to every trust or decedent's estate existing on [the  
4 effective date of this [Act]] except as otherwise expressly provided in the will or terms of  
5 the trust or in this [Act].  
6