

MINUTES OF THE HOUSE COMMITTEE ON JUDICIARY

The meeting was called to order by Chairperson Michael R. O'Neal at 3:30 p.m. on February 9, 2000 in Room 313-S of the Capitol.

All members were present except:

Representative Tony Powell - Excused
Representative Candy Ruff - Excused

Committee staff present:

Jerry Ann Donaldson, Legislative Research Department
Jill Wolters, Office of Revisor of Statutes
Cindy O'Neal, Committee Secretary

Conferees appearing before the committee:

John McCabe, Uniform Law Commissioners

Hearing on **HB 2501 - Enacting the Uniform Principal & Income Act**, was opened.

John McCabe, Uniform Law Commission, explained that the trustee and the personal representative satisfy their obligations by making the proper allocations of assets to either principal or to income. Assets allocated to principal serve the interests of remainder beneficiaries of a trust, and the interest of the final distributees of the assets in an estate. Assets allocated to income meet the requirements of income beneficiaries during the life of a trust, and those beneficiaries who must be paid out of the income derived during administration of an estate. He proceeded to explain some aspects of the proposed bill. (Attachment 1 & 2)

The Uniform Law Commissioners (ULC) enacted the first Uniform Principal and Income Act in 1913. There was a revision in 1962 and now, 35 years after that revision the ULC has recommended a major revision. The purpose of the new act is to provide procedures for trustees administering an estate in separating principal from income and to ensure that the intention of the trust creator is the guiding principal for trustees. Seven states have adopted the revisions and nine have introduced them during their 2000 Legislative Session. (Attachment 3)

HB 2805 - Theft detection shielding devices

Representative Carmody made the motion to report HB 2805 favorably for passage. Representative Long seconded the motion. Representative Pauls wanted to exclude film shielding devices but didn't have any suggested language. The committee postponed further action on the bill.

HB 2775 - Abatement of common nuisances adding felonies committed by gang members to list of unlawful activities

Representative Loyd requested that the California provisions be included in the bill, but didn't have the current language. The committee postponed further action on the bill.

HB 2209 - Wage garnishment, assignment of account, benefit entitlement restriction

Representative Carmody made the motion to report HB 2209 favorably for passage. Representative Loyd seconded the motion.

Representative Carmody made a substitute motion to change the reference on page 2, lines 41 & 42 from the "Federal Act" which has been repealed to "United State Bankruptcy Code". Representative Loyd seconded the motion. The motion carried.

Representative Carmody made the motion to allow the revisors office to change the reference of "1998 supplements" to "1999 supplements". Representative Lightner seconded the motion. The motion carried.

Representative Pauls was concerned that child support would no longer be a priority in assignment of accounts. Therefore the committee postponed further action on the bill until staff researched the issue.

The committee meeting adjourned at 4:30 p.m. The next meeting was scheduled for Thursday, February 10, 2000.

National Conference of Commissioners on Uniform State Laws

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UNIFORM PRINCIPAL AND INCOME ACT (1997)

- A SUMMARY -

A trustee of a trust and the personal representative of a decedent's estate are called fiduciaries. They have special duties toward those who benefit from their administration. A trustee of a trust has a fiduciary obligation to satisfy both the interests of the trust's income beneficiaries during the life of the trust, and the interests of the remainder beneficiaries at the trust's termination. A personal representative may be required to allocate net income to certain individuals during the administration of the estate and to assure that certain expenses are paid out of an appropriate category of interests before finally distributing the assets of the decedent's estate to the heirs or devisees (heirs if there is no will, devisees if there is a will).

The trustee and the personal representative satisfy their obligations by making the proper allocations of assets to either principal or to income. Generally, assets allocated to principal serve the interests of remainder beneficiaries of a trust, and the interests of the final distributees of the assets in an estate. Assets allocated to income meet the requirements of income beneficiaries during the life of a trust, and those beneficiaries who must be paid out of the income derived during administration of an estate.

But the identification of principal and income, its allocation, and apportionment of assets between income and principal have always been a very tricky business. Distinguishing income from principal is not always self-evident. Therefore, the law has provided trustees with statutory help for a very long period of time. The Uniform Law Commissioners promulgated the first Uniform Principal and Income Act in 1931. A revision was promulgated in 1962. Almost all of the states in the United States have adopted one or the other of these earlier acts by 1997, when a new revision once again has been promulgated.

In 1997, 35 years after the 1962 revision, the Uniform Law Commissioners have promulgated the Uniform Principal and Income Act (1997) (UPIA 1997). Obsolescence over time is not the only stimulus for promulgating UPIA 1997. In the 1990's and especially since the promulgation of the Uniform Prudent Investor Act in 1994, a trustee's obligation to invest the assets of a trust as a prudent investor would invest them, has substantially altered the fiduciary obligations of a trustee. There is a strong relationship between the obligation to invest as a prudent investor and the

obligation to satisfy income and remainder beneficiaries. The earlier Uniform Principal and Income Acts do not accommodate prudent investor rules. UPIA 1997 does, as will be discussed a little later in this summary.

UPIA 1997 provides some basic answers to questions that any trustee must ask in dealing with trust assets, and that personal representatives need to ask in the administration of an estate. The first question is whether an asset that becomes a trust or estate asset is either principal or income? Once established as either principal or income, the next question is, when is a beneficiary entitled to receive that asset?

The answers to these questions are strongly affected by the time at which the question is asked. There are three relevant times to consider - the time before creation of an income interest, the time during which an income interest is current and the time after the income interest ends (an income interest is merely the interest of the income beneficiary - the right to receive current payment). The time influences allocation of assets to principal or to income, and ultimately the rights of income and remainder beneficiaries.

The beginning and the end of the income interest are key, because 1) sometimes assets that would otherwise be income are allocated to principal if there is no current income interest; and 2) even if assets are allocated to income, when there is no current income interest, remainder beneficiaries will be entitled to a share of that income.

INITIAL RULE

The express language of the trust instrument, will or other applicable document will govern, notwithstanding conflict with any statutory rule. UPIA 1997 is entirely a default statute that operates only when the governing instrument is silent.

ALLOCATION TO PRINCIPAL OR INCOME

Principal is fundamentally defined as the property held in trust for distribution to a remainder beneficiary when the trust terminates. Income is the current return that any fiduciary receives from an asset that is principal. It has never been sufficient to provide a bare general definition in any of the Uniform Principal and Income Acts. There is, therefore, a group of rules that establish what is principal and what is income with respect to specific kinds of assets.

UPIA 1997 refines old rules and provides specific rules for assets that are not accounted for in the earlier acts. An example of the refinement of old rules concerns receipts from an entity. The earlier uniform acts provide for corporate distributions, generally allocating ordinary dividends to income and any other distribution in the form of additional equity to principal. UPIA 1997 addresses the broader category of receipts from an "entity." A corporation is an entity, but so is a partnership, a limited liability company, a regulated investment company and a real estate investment trust. UPIA 1997 allocates the receipts from all entities in the same manner.

UPIA 1997 then simplifies the allocation question. Any "money" received by a fiduciary is regarded as income, unless it fits certain categories. For example, if money is received as part of a liquidation of the entity, it is principal. If money is received from an investment company (mutual fund) that labels a distribution as capital gain, the receipt is principal. All property received that is not money, i.e., a stock distribution, is principal. In addition, UPIA 1997 establishes what qualifies as a partial or complete liquidation of an entity. Fiduciaries will, thus, be better able to make judgments about receipts that are part of a liquidation. This is a more precise and logical set of rules for making allocations than exists in the earlier uniform acts, making fiduciaries' decisions easier and more certain.

There are certain kinds of assets that UPIA 1997 provides for that are just not within the scope of consideration in the earlier acts. One of them is derivatives. Another is asset-based securities. Receipts from derivatives, unless a trustee exercises powers available in the conduct of a business held in trust, are principal. Receipts from asset-based securities are either income or principal, depending upon the categorization of the asset backed security's payor.

APPORTIONMENT ISSUES

The beginning point and the ending point of an income interest in an estate or a trust provide particular problems, even though the incoming assets would clearly be income under the rules applied during the life of the income interest. Depending upon the time of receipt, an asset that is otherwise classified as income may have to be apportioned at least in part to principal to balance beneficiary interests. UPIA 1997 more precisely and simply provides for that apportionment than the earlier acts did.

UPIA 1997 provides, generally, that an income receipt is principal if it is due before a decedent dies in the case of an estate or before an income interest begins in the case of a trust. After death or after an income interest begins, it is classified as income. If there is income that is not distributed at the time the income interest ends, generally it is paid to income beneficiaries. But if the trust is revocable by an income beneficiary at an amount more than five percent of the trust's corpus immediately before the income interest ends, the undistributed income allocable to the revocable part, must be added to principal.

RIGHT TO PAYMENT

UPIA 1997 expressly requires distribution of net income and principal receipts to the appropriate beneficiaries when a decedent dies or when an income interest ends. There is discretion given to pay certain expenses out of either principal or income unless there is an adverse effect on estate tax marital deductions or income tax charitable deductions. General expenses of an estate are paid from principal. A specific pecuniary amount required to be paid, is paid from income unless insufficient. The deficiency is paid from principal. If there is any net income after the fact, it is distributed to remainder beneficiaries according to share in principal.

These rules assure orderly distribution of income when the decedent dies or an income interest ends. The earlier uniform acts make no attempt to deal with this distribution problem.

ADJUSTMENT POWERS

For Prudent Investment

A trustee must use prudent investment rules in any state that has adopted the Uniform Prudent Investor Act or equivalent statute, and in any case governed by the Restatement of the Law of Trusts III. The investment policy governing a trust's assets depends upon making the appropriate risk/return analysis and investing accordingly. Asset growth can be as significant an objective as income in setting the investment policy for a specific trust. Because a trustee may weight either growth or income significantly in making investment decisions, and because either may be greater or less than anticipated, the trustee may have to rebalance the interests of remainder and income beneficiaries as a result.

UPIA 1997 allows the trustee to adjust principal and income to the extent made necessary by prudent investment when a trust provides for a fixed income for the income beneficiary. This must be a careful decision before which "a trustee shall consider all of the factors relevant to the trust and its beneficiaries." The express list of factors includes "the nature, purpose, and expected duration of the trust"; and "the intent of the settlor." This is not a decision to be taken lightly - the list of express factors to consider is long. Adjustments are forbidden in certain circumstances, such as when they diminish "the income interest in a trust that requires all of the income to be paid at least annually to a surviving spouse and for which an estate tax or gift tax marital deduction would be allowed..." or "if the trustee is a beneficiary of the trust..." This list of forbidden situations, also, must be read with some care before a trustee decides to adjust allocations.

The earlier Uniform Acts did not deal with adjustment as a result of prudent investment. The whole notion of prudent investment, modern portfolio theory and total return came later than either of the two earlier acts. UPIA 1997 is absolutely necessary to making prudent investment work to its full capacity.

For Disbursements during the Administration of a Trust

Expenses and taxes must be paid during the administration of a trust. From which side of the ledger are they to be paid? Generally, UPIA 1997 provides for payment of ordinary expenses out of income, for payment of compensation to the trustee and legal proceedings from principal and income, dividing expenses in two, and payment of expenses peculiar to the remainder interest to principal. A trustee may transfer income to principal to make up for depreciation of an asset or to reimburse principal for disbursements that enhance income, i.e., repairs to assets that are necessary to maintain income. A trustee may make adjustments to principal and income to offset "shifting of economic interests or tax benefits between income and remainder beneficiaries" in certain instances.

During the Conduct of a Business Held in Trust

Under UPIA 1997, a trustee who conducts a business held in a trust may separate out the accounting for the business from that for other trust assets. The trustee, also, has the power to allocate net cash receipts to “working capital, the acquisition or replacement of fixed assets, and other reasonably foreseeable needs of the business or activity, and the extent to which the remaining net cash receipts are accounted for as principal or income in the trust’s general accounting records.”

The earlier uniform acts treated net profit from a business as income, and losses as principal. There is no flexibility.

For Tax Purposes

UPIA 1997 allows a fiduciary to make adjustments between principal and income for tax purposes. Tax liabilities may accrue to either income or remainder beneficiaries. A fiduciary may have to make elections under the tax laws. Imbalances of interests that arise because of taxes can be remedied by the fiduciary.

The earlier uniform acts did not provide such discretion to the fiduciary.

CONCLUSION

It is essential for the drafting and administration of wills and trusts that UPIA 1997 be adopted in every state and jurisdiction as soon as possible. Drafting of instruments becomes considerably harder without a modern set of rules that, among other things, allows adjustment because of prudent investment decisions and because of tax laws. If an instrument is not adequately drafted, trustees will not be able to meet fiduciary obligations. The result will be, higher costs for setting up trusts, more conflict between trustees and beneficiaries and excessive litigation. UPIA 1997 will make life much easier for personal representatives, trustees and beneficiaries alike.

Founded in 1892, the National Conference of Commissioners on Uniform State Laws is a confederation of state commissioners on uniform laws. Its membership comprises more than 300 attorneys, judges, and law professors, who are appointed by each of the 50 states, the District of Columbia, Puerto Rico, and the U.S. Virgin Islands, to draft uniform and model state laws and work toward their enactment.

A Few Facts About

THE UNIFORM PRINCIPAL AND INCOME ACT

PURPOSE: This act revises the Uniform Principal and Income Act of 1931 and 1962, which has been adopted in 41 states. The purpose of the new act, like its predecessors, is to provide procedures for trustees administering an estate in separating principal from income, and to ensure that the intention of the trust creator is the guiding principle for trustees. A revision is necessary so that principal and income allocation rules can function with modern trust investment practices.

ORIGIN: Completed by the Uniform Law Commissioners in 1997.

ENDORSED BY: American Bar Association

STATE ADOPTIONS:	Arkansas	North Dakota
	California	Oklahoma
	Connecticut	Virginia
	Iowa	

2000 INTRODUCTIONS:	Colorado	Michigan
	District of Columbia	Minnesota
	Hawaii	Nebraska
	Illinois	Vermont
	Kansas	

For any further information regarding the Uniform Principal and Income Act (1997), please contact John McCabe or Katie Robinson at 312-915-0195.

(2/5/00)

(Please note: This information can also be found on our Web Site at www.nccusl.org)

1997 Principal and Income Act Reflects Modern Trust Investing

The 1997 Principal and Income Act gives trustees guidance in light of (1) the new prudent investor rule, which emphasizes investing for total return, and (2) new investment vehicles, such as derivatives, that are available today.

DAVID W. KEISTER AND WILLIAM J. MCCARTHY, JR., ATTORNEYS

At its annual conference in 1997, the National Conference of Commissioners on Uniform State Laws adopted the 1997 Uniform Principal and Income Act (the 1997 Act).¹ The Conference had two primary objectives in developing new principal and income legislation. First, revisions were needed to update earlier incarnations of the Act—the 1931 Uniform Principal and Income Act (the 1931 Act)² and the 1962 Revised Uniform Principal and Income Act (the 1962 Act).³ Second, the Conference sought to add new provisions giving trustees greater freedom to make investments that comport with modern investment practices and the Uniform Prudent Investor Act.

Principal and income legislation is default legislation that deals with various principal and income

allocation issues left unresolved by the governing will or trust instrument. In general, its provisions guide a fiduciary in determining whether receipts and disbursements should be classified as income or as principal. The 1997 Act, like earlier versions of the Act, addresses the distribution of income earned during estate administration, identifies the recipient of income when a trust income interest begins and ends, and directs the allocation of receipts and disbursements between income and principal during the administration of a trust.

Recognizing that the old rules needed to be updated in a number of areas, the drafters expanded the scope of the 1997 Act to cover modern planning techniques and new investment vehicles. But the 1997 Act takes another, extremely significant, step. It allows a trustee, under certain circumstances, to recharacterize income as principal, and principal as income, if the trustee believes such an adjustment is necessary to treat the beneficiaries impartially (this measure is discussed more later).

The nuts-and-bolts provisions of the 1997 Act

Allocation of income during estate administration. Article 2 of the 1997 Act contains rules that govern allocation of income earned during the probate of an estate. In large part, these rules dictate who among the beneficiaries of an estate will receive the income generated during administration.

Following the traditional rule, the 1997 Act provides that a beneficiary of property specifically bequeathed under a will alone receives the net income produced by the property.⁴ A new rule of the Act, however, allows the executor, in determining the remaining income of the estate, to use its discretion to decide whether to charge fiduciary's and attorney's fees, administration expenses, and interest on death taxes against income or against principal.⁵

The freedom to make this choice will largely eliminate the need for equitable adjustments when the allocation of a particular expense may lead to a mismatched tax benefit, such as when an expense paid from principal gives rise to an

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income tax deduction favoring the income beneficiaries. Under the 1997 Act, the expense can be paid from income to the extent necessary to create a fair result.

Furthermore, the executor may be able to take advantage of tax planning opportunities by making certain allocations of estate expenses. Recent case law may have opened the door to new opportunities. In *Estate of Hubert*,⁶ the U.S. Supreme Court considered an estate in which expenses (1) were paid from income that was generated by assets passing in trust for a surviving spouse or for charity, and (2) were deducted for income tax purposes. Payments out of the principal of such assets would have diminished the estate tax marital or charitable deduction.⁷

But the Supreme Court held that the payment of expenses out of income otherwise payable to a surviving spouse or to charity does not reduce the estate tax marital or charitable deduction, so long as the payments do not constitute a material limitation on the spouse's or charity's entitlement to income. The 1997 Act conforms to the Supreme Court's decision in

Hubert by providing that expenses may be paid from income of property passing to a marital or charitable trust only to the extent that paying such expenses from income does not eliminate or reduce the marital or charitable deduction.⁸

Once the estate's remaining income is determined, the 1997 Act prescribes the method for its distribution. A beneficiary who receives an outright pecuniary gift is entitled to receive the interest or other income as directed by the governing instrument, or, if it is silent, as provided by applicable state law.⁹ The balance of the income is distributable to the residuary beneficiaries, including trusts entitled to pecuniary amounts, in proportion to their respective interests in the undistributed assets just before the distributions are made.¹⁰ Gains and losses realized during administration (ignored by the prior Acts) may be distributed in the same manner.¹¹ In an attempt to simplify the process, the executor is allowed to use asset values from a date reasonably near the date of distribution.¹²

Under the prior Acts, these rules applied only to estates; nothing

was said about similar issues that arose during the termination of a trust interest. Now, thanks to an expansion of the scope of the 1997 Act, the estate rules apply to the winding-up period of inter vivos trusts. For example, a trust asset specifically given to a beneficiary by the trust's terms at the time the trust ends—like a specific bequest under a will—carries out to the beneficiary whatever net income may be generated by the property.¹³

And, if a pecuniary amount passes outright to a trust beneficiary upon the trust's termination, the beneficiary receives the same interest or other income amount that would have been received had the pecuniary gift been made under a will.¹⁴ The expansion of these rules to trusts will be particularly useful where revocable living trusts fulfill substantially the same function as a probate estate.

Apportionment of income and principal when trust interest begins and ends. Article 3 of the 1997 Act explains how income from trust assets is to be apportioned at the time a trust income

¹ At its 1997 annual meeting, the Conference approved the 1997 Act and recommended its enactment in all states. To become law in a state, the 1997 Act must be enacted into law by the state, either in its original form or as may be revised by the state. At this writing, Oklahoma was the only state that had enacted provisions of the 1997 Act into law. Bills have been introduced in the legislatures of Hawaii, Nebraska, Virginia, and West Virginia, and several other states are currently considering the Act. For more information on the 1997 Act, contact the National Conference of Commissioners on Uniform State Laws, 211 E. Ontario St., Ste. 1300, Chicago, IL 60611; (312) 915-0195; www.nccusl.org. The 1997 Act and comments are located at www.law.upenn.edu/library/ulc/ulc.htm.

² Handbook of the National Conference of Commissioners on Uniform State Laws and Proceedings of the Forty-First Annual Conference, p. 328 (1931).

³ Handbook of the National Conference of Commissioners on Uniform State Laws and Proceedings of the Annual Conference Meet-

ing in its Seventy-First Year, p. 251 (1962).

⁴ Uniform Principal and Income Act (1997) (hereinafter referred to as the 1997 Act) section 201(1).

⁵ 1997 Act section 201(2)(B).

⁶ 520 U.S. 93, 79 AFTR2d 97-1394 (S.Ct., 1997).

⁷ Reg. 20.2056(b)-4(a).

⁸ 1997 Act section 201(2)(B). On 12/16/98, the IRS issued Proposed Regulations addressing the *Hubert* issue of whether certain payments from income reduce the marital or charitable deduction. See REG-114663-97, 63 Fed. Reg. 69248 (12/16/98). The Proposed Regulations dispense with the concept of materiality and instead divide administration expenses into two kinds: one kind which, if charged to marital or charitable property, will reduce the marital or charitable deduction, and another kind which, if so charged, will not. "Estate management expenses"—expenses incurred in connection with the investment of the marital or charitable property and with its preservation and maintenance during the period of administration—will not

reduce the marital or charitable deduction, regardless of whether paid from the income or principal of such property. All other administration expenses, including those incurred in the collection of the decedent's assets, the payment of the decedent's debts and death taxes, and the distribution of the decedent's property—called "estate transmission expenses"—will reduce the deduction if paid out of the income or principal of the marital or charitable property. If these Regulations as initially proposed become final, states contemplating enactment of the 1997 Act should consider revising section 201(2)(B) to reflect the fact that the Regulations make no distinction between payments from income and payments from principal in resolving whether expenses reduce the marital or charitable deduction.

⁹ 1997 Act section 201(3).

¹⁰ *Id.* sections 201(4) and 202.

¹¹ *Id.* section 202(d).

¹² *Id.* section 202(b)(4).

¹³ *Id.* section 201(1).

¹⁴ *Id.* section 201(3).

interest begins and at the time it ends. Initially, Article 3 identifies when a trust income interest actually begins and ends. If a starting date is stated in the trust instrument, that date controls. If no date is specified, the income interest begins at the time a transfer is made to the trust, if the transferor is living, or on the date of the transferor's death, if the transfer is testamentary in nature or made by a third party because of the transferor's death.¹⁵ Generally, an income interest ends on the day just before the date of the income beneficiary's death or other terminating event stated in the trust instrument.¹⁶

With regard to the allocation of trust income when an income interest begins, the 1997 Act provides that a periodic payment (such as rent or dividends) is always credited to principal if it becomes due before the income interest begins.¹⁷ If the next periodic payment is due after the income interest has begun, it is allocated entirely to income.¹⁸ Thus, apportionment of a periodic payment never occurs; this approach is a departure from the 1962 Act. On the other hand, nonperiodic payments (such as interest on an income tax refund) are apportioned between income and principal; the part of the payment that accrues before the income interest begins or before the decedent dies is considered principal, and the balance of the payment is income.

There are new rules that apply to apportionment when an income interest ends. Under the prior Acts, any accrued but undistributed income existing at the time of the income beneficiary's death belonged to that beneficiary's estate. The 1997 Act provides that the income beneficiary's estate is

entitled only to income actually received by the trustee before the income beneficiary's death.¹⁹ Other income that may have accrued, but not been received by the trustee, before death is added to the principal of the succeeding interest.²⁰ Thus, such undistributed income benefits the remainder beneficiaries of the trust rather than the takers of the income beneficiary's estate; the drafters of the 1997 Act believed this regime would be more in line with the intentions of most settlors.

Allocation of items during trust administration. The 1997 Act retains some of the rules from the prior Acts with regard to the allocation of receipts and disbursements between income and principal during the administration of a trust. Nevertheless, Article 4 of the Act introduces new rules that change the way trustees will make these allocations.

The 1997 Act identifies certain trust receipts that are normally not apportioned—i.e., they are tagged as either all income or all principal. The Act continues the familiar rule that cash or other property from the sale or exchange of a principal asset retains its character as principal.²¹ But the Act clarifies that other kinds of receipts of a less-obvious nature are also considered principal under all-or-nothing-type rules. For example, with regard to bonds and other obligations acquired at a discount (e.g., zero-coupon bonds), the amount received upon redemption or sale of these obligations will be deemed completely principal if the obligation had a maturity of a year or more. If the obligation matures within a year, the proceeds in excess of its purchase price will be considered entirely income.²²

As to bonds and other obligations paying interest, the interest—whether determined at a fixed, variable, or floating rate—will be income even if the obligation was bought at a premium.²³ Receipts from rental property, including amounts received for cancellation or renewal of a lease, are generally allocated all to income.²⁴

With regard to receipts that are ordinarily apportioned, the 1997 Act offers some new approaches to dividing the amounts between income and principal. Under the 1962 Act, annual payments under a deferred compensation contract and receipts from property subject to depletion (i.e., wasting assets) are allocated to income to the extent of 5% of the asset's inventory value; the rest is added to principal. Therefore, the income portion of each year's payments is tied to the initial value of the property and to the applicable interest rate at the decedent's death, regardless of the amount actually distributed from year-to-year.

The 1997 Act changes the focus and makes the allocation dependent on the distribution amount received. With respect to deferred compensation arrangements, including qualified retirement plans and IRAs, the 1997 Act provides generally that 10% of any distribution required to be made (e.g., a minimum required distribution from an IRA) must be allocated to income and the balance to

¹⁵ *Id.* section 301(b).

¹⁶ *Id.* section 301(d).

¹⁷ *Id.* section 302(a).

¹⁸ *Id.* section 302(b).

¹⁹ *Id.* section 303.

²⁰ *Id.*

²¹ *Id.* section 404(2).

²² *Id.* section 406(b).

²³ *Id.* section 406(a).

²⁴ *Id.* section 405.

principal.²⁵ Payments not required to be made under such plans are all principal. If additional amounts must be allocated to income in order to qualify for an estate tax marital deduction, the Act requires the trustee to make whatever larger allocation to income is necessary to qualify.²⁶

Payments from liquidating assets expected to generate receipts for only a limited time (such as a patent, copyright, or royalty right) are subject to the same 10% income-90% principal allocation.²⁷ Similarly, receipts from oil, gas, and other natural resource interests are generally allocated 10% to income and 90% to principal.²⁸ This is a marked departure from the 1962 Act, under which 27-1/2% of the gross receipts from natural resources (but not more than 50% of the net receipts after payment of expenses) were allocated to principal as a depletion allowance. Proceeds from the sale of timber are treated separately under the 1997 Act; the allocation to income depends on whether the amount of timber removed from the land exceeds or trails the timber's rate of growth.²⁹

The 1997 Act addresses allocation issues relating to unique investment vehicles not contemplated by the 1931 or 1962 Acts. For example, derivatives, options, and asset-backed securities are dealt with under specific provisions of the 1997 Act that are tailored to those assets.³⁰

Receipts from corporations, partnerships, limited liability companies (LLCs), and other similar entities are given unique treatment under the 1997 Act. The Act generally follows a simple rule: money received from the entity is allocated to income, and receipts other than money are allocated to principal.³¹ There are exceptions to this general rule, however.

For example, money received in total or partial liquidation of the entity would fall into the principal, rather than the income, account. Under the Act, partial liquidations can occur in either of two ways. First, if the entity indicates that a distribution is a partial liquidation, then it is so treated. Second, a distribution, or series of related distributions, that exceeds 20% of the entity's gross assets is treated as a partial liquidation

whether or not the entity described it as a partial liquidation.³²

If a trustee conducts a business, the trustee may opt out of the regime just discussed and account for the business separately under rules that grant the trustee greater flexibility in allocating items between income and principal.³³ The trustee is authorized to retain receipts from the entity for the reasonable needs of the business, and any remaining amounts will be classified as income or principal as the trustee deems appropriate. Accordingly, the trustee is able to tailor income and principal allocations to fit the particular requirements of the business. Before operating under this system, though, the trustee must determine that it is in the best interest of all beneficiaries to account separately for the business.

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²⁵ *Id.* section 409(c).

²⁶ *Id.* section 409(d).

²⁷ *Id.* section 410(b).

²⁸ *Id.* section 411.

²⁹ *Id.* section 412.

³⁰ *Id.* sections 414 and 415.

³¹ *Id.* section 401(b).

³² *Id.* sections 401(c)(3) and 401(d).

³³ *Id.* section 403.

The 1997 Act, in Article 5, generally adheres to familiar rules regarding allocation of disbursements during the administration of a trust. For example, the 1997 Act follows the 1962 Act in charging to income the ordinary expenses incurred in administering a trust, such as interest, ordinary repairs, and real estate taxes.³⁴ Also charged to income are one-half of trustee and investment advisory fees and expenses for accountings, judicial proceedings, or other matters involving both income and remainder interests. The other one-half of those items are allocated to principal.³⁵

The 1997 Act makes clear that estate, inheritance, and other transfer taxes assessed against the trust come out of principal. Generally, income tax payable by the trustee on ordinary income is paid from income, while capital gains tax is paid from principal.³⁶ In a new provision, environmental expenses, including costs of assessing and remedying environmental contamination, are generally allocated to principal.³⁷

The trustee's power to adjust

The most often discussed—and debated—provision of the 1997 Act is section 104, which gives trustees a new power to make adjustments between income and principal. This new power was added to the Act, in large part, to enable the trustee to treat income and remainder beneficiaries fairly under an investment regime that conforms to the principles of modern portfolio theory and seeks total return. The power also allows a trustee to adjust income and principal where strict allocation requirements under other provisions of the Act may lead to inequitable results.

Coordination with the prudent investor rule. Spurred by events and reforms of recent years, modern portfolio theory has been gaining acceptance as the foundation of trust investment law. The Restatement of Trusts (Third): Prudent Investor Rule (completed in 1992) and the Uniform Prudent Investor Act (approved in 1994), which incorporate the tenets of this theory, have helped shift the focus away from the suitability of each separate investment to the modern approach of considering the portfolio as a whole.

Under the prudent investor rule, the various stocks, bonds, and other trust assets that together form the portfolio are viewed as interrelated pieces of the entire investment program. The total return (i.e., income and capital appreciation) of the whole portfolio at an appropriate risk level—instead of the isolated performance of each investment—is paramount.

The unfortunate reality is that the modern investment approach clashes with the traditional way of structuring trusts. The familiar design of a trust is to give the current beneficiary a right to the net income earned by the trust, and to give the future remainder beneficiary what is left when the income interest ends. The interests of the beneficiaries are dependent on what is considered income and what is considered principal. Under the old investment standards, where the trustee could focus on each investment in isolation, the trustee felt free to invest in “safe” vehicles that produced a reasonable flow of income, but relatively little capital appreciation. Although the total return of the overall portfolio may have suffered, the trustee was able to point

to the propriety of each investment.

Now, with the shift in emphasis to the performance of the whole portfolio, there is a tension between investing for total return and meeting the traditional income and principal allocations. In periods of moderate-to-low interest rates (such as we are in now), a strategy of investing for total return may not generate income of an amount that traditionally has been accorded an income beneficiary.

For example, a large allocation of assets in low-yielding stocks or stock mutual funds in order to boost total return may skew the return away from income towards principal growth, shortchanging the income beneficiary. On the other hand, if the trustee lowers equity exposure and invests heavily in vehicles with greater income yields, the total return may be diminished.

Section 104 of the 1997 Act would give the trustee the ability to move principal to income and income to principal in order to make up insufficiencies in either resulting from investment choices made pursuant to the prudent investor rule. In the previous example, assuming the requirements of section 104 are met, the trustee could transfer principal to income to provide a reasonable current return for the income beneficiary. If no such power existed, the trustee would be torn in two directions, and would likely be forced to invest substantially in higher-yielding, lower-total-return investments in order to pay a reasonable amount to the income beneficiary.

³⁴ *Id.* section 501(3).

³⁵ *Id.* sections 501(1), 501(2), and 502(a)(1).

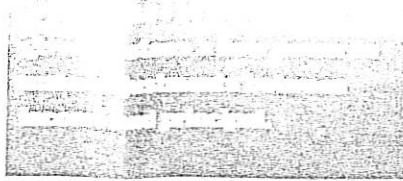
³⁶ *Id.* section 505.

³⁷ *Id.* section 502(a)(7).

Ground rules for exercising the power to adjust. The new Act and the accompanying comments carefully set forth the circumstances under which a trustee may exercise its power to adjust. A trustee may make adjustments between income and principal if: (1) the trustee invests and manages trust assets in accordance with the prudent investor rule; (2) the trust instrument describes the income beneficiary's distribution rights in terms of fiduciary accounting income; and (3) the trustee is unable, without exercising the power to adjust, to administer the trust impartially or to achieve the degree of partiality required or permitted by the governing instrument.³⁸

The first condition above (i.e., that the trustee invest and manage trust assets as a prudent investor) will be met in situations where the terms of the governing instrument require investing in accordance with the prudent investor rule or where controlling state law requires the same—either because of the enactment of a prudent investor act or because the courts have adopted the prudent investor rule. The second condition is met generally when the governing instrument requires the trustee to distribute the income to a beneficiary or among a number of beneficiaries.³⁹

The third condition requires the trustee to proceed through several steps. First, the trustee must apply the principal and income allocation rules provided in the governing instrument or, if silent, the rules of the Act. Second, the trustee must determine whether the trust terms call upon the trustee to favor one or more beneficiaries. Finally, the trustee must conclude that it is unable to administer the trust impartially, or that it is unable to achieve the degree of par-



tiality required or permitted, without exercising the power to adjust.⁴⁰

Power to adjust prohibited under certain circumstances. Even if the three conditions discussed above are met, a trustee will not be permitted to exercise its power to adjust under a number of circumstances set forth in section 104. The first set of circumstances under which a trustee is prohibited from exercising its power to adjust is designed to preserve tax benefits that may have been important to the settlor in establishing the trust.⁴¹

For example, a trustee may not exercise its power to adjust where such exercise (1) would diminish the income interest of a spouse in a trust for which a QTIP election is made; (2) would reduce the actuarial value of a trust income interest where the intent is to qualify for the gift tax exclusion; or (3) would change the amount payable to the current beneficiary under a private or charitable annuity trust or unitrust. Furthermore, a trustee may not make an adjust-

ment if that adjustment would reduce an amount permanently set aside for charitable purposes unless both the income and principal are set aside for such purposes.

The second group of circumstances under which the adjustment is disallowed is designed to prevent adverse tax consequences.⁴² An individual trustee will not have a power to adjust if possessing such a power will cause the individual to be treated as the owner of all or part of the trust for income tax purposes, and the individual would not have otherwise been treated as the owner. Moreover, an individual who can remove and/or appoint a trustee will not have a power to adjust if possessing or exercising the power will cause all or part of the trust assets to be included in the individual's estate for estate tax purposes, and the assets would not otherwise have been included.

Under section 104(c)(7), a trustee cannot exercise a power to adjust if the trustee is a beneficiary of the trust, whether or not possession of the power may have adverse tax consequences. And no adjustment is allowed when it would benefit the trustee directly or indirectly, even if the trustee is not a beneficiary. If there is more than one trustee, a co-trustee to

³⁸ *Id.* section 104(a).

³⁹ The comments to section 104 of the 1997 Act indicate that this requirement will also be satisfied in certain situations where the trustee may, in its discretion, distribute or accumulate some or all of the income.

⁴⁰ 1997 Act, sections 104(a), 103(a), and 103(b). A trustee must consider all factors relevant to the trust and its beneficiaries in deciding whether and to what extent to exercise the power to adjust. Section 104 contains a non-exclusive list of factors to be considered. These factors include: (1) the nature, purpose, and expected duration of the trust; (2) the settlor's intent; (3) the circumstances of the beneficiaries; (4) the need for liquidity, revenue stream, and preservation and appreciation of trust corpus; (5) the nature of the assets held in the trust; (6) other allo-

cations to income pursuant to other provisions of the Acts and the increase or decrease in the value of the principal assets; (7) the trust terms and past practice regarding principal invasions and accumulation of income; (8) the current and projected economic conditions; and (9) the anticipated tax consequences of an adjustment. *Id.* section 104(b). In exercising the power to adjust, as may be necessary to be impartial toward the beneficiaries (or to favor a beneficiary if required or allowed under the governing instrument), the trustee's determinations in accordance with the 1997 Act are presumed to be fair and reasonable to all the beneficiaries. *Id.* section 103(b).

⁴¹ *Id.* sections 104(c)(1), 104(c)(2), 104(c)(3), and 104(c)(4).

⁴² *Id.* sections 104(c)(5), 104(c)(6), and 104(c)(8).

whom the above provisions do not apply may make adjustments unless prohibited by the instrument.

Application of the power to adjust

The section 104 power to adjust is an innovative, but controversial, provision of the 1997 Act. Some practitioners have suggested that section 104 provides scant guidance as to when the trustee should exercise the power, leaving the trustee to fend for itself in using it. Critics have also questioned whether section 104 is even necessary, believing that trustees experience no real tension in day-to-day practice between modern investment objectives and traditional principal and income law.

We largely disagree with these objections, and find section 104 a welcome development in the principal and income area. Section 104 preconditions its application on a number of well-conceived tests and considerations, which serve as guideposts for the trustee. In addition, section 104 helps the trustee resolve real, not imagined, conflicts that trustees actually encounter. An example illustrating the application of the power to adjust in a "real-world" situation may bring these issues into sharper focus:

Example. ABC Trust Company has just become the successor trustee of a trust that pays all the net income to the settlor's sister Sarah for life, remainder to John, who is Sarah's son. The predecessor trustee has delivered the trust assets—40% stocks and 60% bonds—to ABC Trust. The terms of the trust allow the trustee to distribute principal to Sarah for her health and to support her in her accustomed manner of living after considering Sarah's other

resources, but the trust terms do not otherwise indicate that either Sarah or John should be favored. Sarah, who is retired, is receiving income from Social Security, a pension, and her savings, which is more than enough to maintain her accustomed manner of living.

After a full analysis, ABC Trust determines that, in order to follow the prudent investor rule, it should realign the portfolio so that stocks constitute 80% and bonds 20%. ABC Trust recognizes, however, that the trust will receive much less interest and dividend income under this approach. ABC Trust need not invade principal because Sarah's standard of living is being maintained by other funds, but, as the only income beneficiary, Sarah is still entitled to receive from the trust that degree of beneficial

enjoyment normally accorded a sole income beneficiary.

ABC Trust considers the three conditions that must be met before a section 104 adjustment can be made, and finds that the prudent investor rule applies, that Sarah is due all of the trust's income, and that, in light of the investment mix for the trust pursuant to prudent investor standards, the remainder beneficiary will be unfairly favored over Sarah if she receives only the traditional accounting income. It is also determined that none of the prohibitions in section 104 against using the power to adjust applies. Upon considering all factors relevant to the trust and its beneficiaries (including those enumerated in section 104), ABC Trust concludes that it should transfer cash from principal to income to boost the current return

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for Sarah and provide her with the degree of enjoyment to which she is entitled.⁴³

In recent years, with the strong performance of the stock market, the asset allocation decisions and resulting income shortfall illustrated in the above example ring true. In times of high inflation and high interest rates, however, the reverse adjustment may be considered appropriate. For example, a trustee serving during a high-inflation period who invests substantially in 12% bonds to achieve a high total return finds itself with significant interest income, but little principal growth. After considering the factors in section 104, this trustee may choose to transfer some of the interest to the principal account in order to treat the remainder beneficiaries fairly.

The use of the power to adjust is not limited to situations in which the trustee's investment actions favor one beneficiary over another. Section 104 contemplates that principal and income allocations under other sections of the Act may at times produce unfair results that will necessitate a section 104 adjustment. The following example illustrates this application of the power to adjust.

Example. XYZ Trust Company is the trustee of a trust for the settlor's two children, Erinn and Ryan, who are entitled to receive all the trust's income, but none of the principal. The trust is the sole beneficiary of the settlor's IRA, which consists of marketable securities valued at \$500,000. The right to payments from the IRA is the only asset held by the trust. The trust receives IRA distributions that are required to be made under the tax laws. The latest distribution is allocated 10% to income

and 90% to principal in accordance with the 1997 Act. As it turns out, the total return on the IRA assets exceeds the amount distributed to the trust, and the IRA's value is greater at the end of the year than it was at the beginning. The amount allocated to income and paid to Erinn and Ryan is less than 1% of the value of the IRA assets. After completing a full analysis under section 104, XYZ Trust determines that a certain amount of principal should be transferred to income in order to treat Erinn and Ryan fairly and impartially.⁴⁴

The above examples illustrate that trustees must go through a careful, deliberative process to make adjustments under section 104. The trustee must consider a number of factors, some of which may involve complex tax-related issues. These matters must be clearly understood by the trustee before the power to adjust can be used as intended. Undoubtedly, it will take a sophisticated trustee to fully grasp the issues and to use the power appropriately in trust administration.

Trustees who will be administering trusts under the 1997 Act may be guided by provisions added to governing will or trust instruments in anticipation of section 104. For instance, section 104 requires that the trustee, before making any adjustment to income or principal, consider whether one or more of the beneficiaries are to be favored over the others under the trust terms.

With respect to a trust involving one income beneficiary and several remainder beneficiaries, the drafter could indicate clearly in the trust instrument, if the settlor so desired, that the income beneficiary is to be favored over the remainder beneficiaries and

that the trustee is to invest for high amounts of income even though the principal may lose value. With these instructions, the trustee would have greater leeway to invest in high income-producing investments without the need to make income-to-principal adjustments on behalf of the remainder beneficiaries. Section 104 is designed to bend to the intentions of the settlor, which are paramount.

Conclusion

The drafters of the 1997 Act have done a commendable job in fashioning new principal and income legislation. The 1997 Act builds upon earlier rules that have stood the test of time, complementing them with new ones that make the law responsive to today's issues. Trustees operating under the new Act will be able to apply rules that in large measure bring consistency, clarity, innovation, and common sense to trust administration. But not all is simple and straightforward with the Act.

The drafters realized that the Act's allocation rules do not yield fair results in all situations. And they realized that the very mission of the Act—clearly resolving division of return into income and principal—makes modern investing under the prudent investor rule difficult. The section 104 power to adjust was added to address these concerns. Although section 104 has been carefully drafted to guide a trustee in its application, it will take a knowledgeable, sophisticated trustee to navigate its provisions successfully. ■

⁴³ This example is based on Examples (1) and (2) in the comments to the 1997 Act, section 104.

⁴⁴ This example is based on Example (5) in the comments to the 1997 Act, section 104.