

TO: Judicial Council
FROM: Probate Law Advisory Committee
DATE: December 13, 2019
RE: Uniform Fiduciary Income and Principal Act

The Probate Law Advisory Committee has reviewed the attached 2018 Uniform Fiduciary Income and Principal Act (UFIPA), which was recently approved by the Uniform Law Commission. The Committee is recommending that the UFIPA be adopted in Kansas with only a few minor changes as reflected in the attached redline draft.

Kansas enacted an earlier version of this Act in 2000 (the Uniform Principal and Income Act) and added a unitrust conversion provision in 2009. The Committee believes the 2018 UFIPA is a useful update. Its main purpose is to provide greater flexibility to trustees in the power to adjust between principal and income. It also contains more detailed unitrust conversion provisions, and it clarifies which state's law applies.

The attached summary from the Uniform Law Commission, "Why Your State Should Adopt the UFIPA," provides a helpful overview of the UFIPA's provisions.



WHY YOUR STATE SHOULD ADOPT THE UNIFORM FIDUCIARY INCOME AND PRINCIPAL ACT

The Uniform Fiduciary Income and Principal Act (UFIPA) provides enhanced, more flexible accounting rules for modern trusts. Current trends in estate planning allow for very long-term trusts that give trustees broad discretion to adapt to future events. UFIPA recognizes these trends and updates the law accordingly.

- ***UFIPA allows total-return investing.*** Modern portfolio theory advocates investing for the greatest possible total return, regardless of whether the return is in the form of income or growth of principal. Outdated laws make this more difficult because of historic legal distinctions between income and principal. UFIPA updates the law and allows trustees to invest for the greatest possible return.
- ***UFIPA contains flexible and innovative unitrust rules.*** The development of modern portfolio theory popularized the use of unitrusts – an easy-to-administer form of trust that helps maximize investment returns and minimize administrative expenses. UFIPA provides the first uniform rules for converting older trusts into unitrusts, with more flexibility than any current state statute but still in accordance with federal tax regulations.
- ***UFIPA allows for individualized estate planning.*** Under UFIPA's flexible rules for trust administration, creative estate planners can tailor the terms of a trust to fit each client's current needs and allow adaptation for unforeseen future events.
- ***UFIPA clarifies which state's law applies.*** UFIPA includes a default rule stating the law governing a trust is the law of the state where the trustee has its principal place of administration. This rule conforms to current practice and will help ensure courts apply the correct law and prevent multi-state jurisdictional disputes.
- ***UFIPA modernizes the law of trusts.*** Nearly every state has adopted a version of the Uniform Principal and Income Act, parts of which date to 1931. UFIPA is an updated version of this uniform law with a new name to differentiate it from its predecessors. Each state should replace its existing law with this latest version appropriate for the twenty-first century.

For further information about UFIPA, please contact ULC Chief Counsel Benjamin Orzeske at (312) 450-6621 or borzeske@uniformlaws.org.

UNIFORM FIDUCIARY INCOME AND PRINCIPAL ACT

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-TWENTY-SEVENTH YEAR
LOUISVILLE, KENTUCKY
JULY 20 - JULY 26, 2018

WITH PREFATORY NOTE AND COMMENTS

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By
NATIONAL CONFERENCE OF COMMISSIONERS
ON UNIFORM STATE LAWS

January 25, 2019

ABOUT ULC

The **Uniform Law Commission** (ULC), also known as National Conference of Commissioners on Uniform State Laws (NCCUSL), now in its 127th year, provides states with non-partisan, well-conceived and well-drafted legislation that brings clarity and stability to critical areas of state statutory law.

ULC members must be lawyers, qualified to practice law. They are practicing lawyers, judges, legislators and legislative staff and law professors, who have been appointed by state governments as well as the District of Columbia, Puerto Rico and the U.S. Virgin Islands to research, draft and promote enactment of uniform state laws in areas of state law where uniformity is desirable and practical.

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- Uniform Law Commissioners donate thousands of hours of their time and legal and drafting expertise every year as a public service, and receive no salary or compensation for their work.
- ULC's deliberative and uniquely open drafting process draws on the expertise of commissioners, but also utilizes input from legal experts, and advisors and observers representing the views of other legal organizations or interests that will be subject to the proposed laws.
- ULC is a state-supported organization that represents true value for the states, providing services that most states could not otherwise afford or duplicate.

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AND PRINCIPAL ACT**

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UNIFORM FIDUCIARY INCOME AND PRINCIPAL ACT

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UNIFORM FIDUCIARY INCOME AND PRINCIPAL ACT

PREFATORY NOTE

The Uniform Fiduciary Income and Principal Act (2018) is an update of the Revised Uniform Principal and Income Act (1997). Like the 1997 Act, it adapts to changes in the design and use of trusts. Highlights include an expansion of the use of the power to adjust between income and principal in Section 203, the addition of provisions for unitrusts in Article 3, and a simplifying change in governing law for purposes of distinguishing income and principal in Section 104.

Changes in the Design and Use of Trusts

The 2018 Uniform Fiduciary Income and Principal Act, like previous revisions of the Uniform Principal and Income Act, is intended to reflect and address changes in the design and use of modern trusts. Very long-term trusts are more common, as are totally discretionary trusts – that is, trusts in which income, as well as principal, is distributable to beneficiaries during the term of the trust not as a matter of right but solely in the discretion of the trustee. Even where income distributions are mandatory, including occasions where income distributions are mandated by requirements of tax law (such as the estate tax marital deduction), discretion in the trustee to supplement income distributions by invasions of principal is common.

One result of these developments in the design, use, and role of trusts is to make historical distinctions between income and principal less important as a technical matter in some cases. Discretionary accumulation of income has the effect of treating income as principal to the extent of the accumulation. And discretionary invasion of principal has the effect of treating principal as income to the extent of the invasion. Even so, the difference between income and principal is important to impartial trustees and beneficiaries alike. The 2018 Act retains the historical distinctions, including the historical technical rules that have evolved through changing legal and practical environments, while still allowing skilled and dedicated trustees to respond to legal and practical environments that inevitably will continue to change.

The basic premise of the current revision is that a trustee that is aware of the current practical environment of trust administration and sensitive to the evolving demands of impartiality should be able to determine standards for adjusting between income and principal that are reasonable in the circumstances, and to update those standards from time to time. Authority to make adjustments between income and principal from year to year, introduced as Section 104 in the 1997 Act, is retained, and indeed significantly expanded, as Section 203 in the 2018 Act. The most important way in which the authority to adjust is expanded is by eliminating the precondition that trust distributions are constricted by the concept of “income” in a way that economic results from year to year could arbitrarily affect. In other words, while the trustee of a more modern trust with greater, if not total, flexibility to make distributions from income and/or principal would actually have been *denied* the flexibility intended by former Section 104, new Section 203 ensures that designing a trust for greater flexibility will not ironically sacrifice the flexibility of adjustments.

That means that the technical structure of the 2018 Act exhibits a certain amount of apparent redundancy. A trustee that could cope with the constraints of income and principal rules by merely accumulating income or invading principal now is given the alternative of making an adjustment under Section 203 instead, either from year to year, as under former Section 104, or for more than one year, under these expanded rules.

The 2018 Act respects, and permits a trustee to respect, the simple notion of “income.” Under Section 203, a trustee of a discretionary trust can make adjustments, taking into account a nonexclusive list of factors provided in Section 201(e), and still achieve the comfortable outcome of “distributing income.” And if the interests of beneficiaries under the terms of the trust are still not appropriately served within the framework of “distributing income” – that is, when no reasonable adjustment would serve those interests, or when non-pro rata distributions are justified – then invasions of principal are still appropriate to the extent consistent with the terms of the trust.

The more traditional rules for allocating income and principal are retained, with updates, in Articles 4 through 7. The general substantive rules are in Articles 4 and 5, and the special temporal rules relating to the beginning and end of interests are moved from Articles 2 and 3 in the 1997 Act to Articles 6 and 7 in the 2018 Act, thus placing the substantive rules that are applicable on an ongoing basis ahead of the temporal rules that are applicable only at certain times. One useful result of these changes is that the former rules of Sections 401 through 415 and 501 through 503, with which many fiduciaries no doubt have considerable experience, are retained in the 2018 Act with the same section numbers.

Article 3 adds the authority for a trustee to convert to or from a unitrust or change a unitrust. But the tax-sensitive limitations typically included in unitrust statutes, such as the limitation of the unitrust rate to a rate from 3 to 5 percent, are now provided only for trusts that are intended to qualify for tax benefits for the protection of which those limitations are needed. The new unitrust rules are discussed further in the Comments in Article 3.

Expansion Beyond Trusts and Estates

Previous Uniform Principal and Income Acts explicitly addressed only trusts and estates, even though they reflected principles that would apply in other contexts where the benefits of property are shared by successive legal or beneficial ownership interests. While those contexts do not necessarily present allocation issues that require the application of specific statutory rules on a regular basis, Section 103(2) of the 2018 Act fills a potential gap by making the act explicitly applicable to “a life estate or other term interest in which the interest of one or more persons will be succeeded by the interest of one or more other persons.”

Governing Law

New Section 104 clarifies that the income and principal rules of the state that is the principal place of administration of the trust from time to time will be the governing law.

A “rule of construction” is typically governed by the law of the place where the trust was created or deemed created. A “rule of administration” is typically governed by the law of the situs of the trust from time to time, often with appropriate savings provisions for tax benefits, etc.

if the situs is changed. Authorities seem to be divided, however, on which historical category includes an income and principal act. See Restatement (Second) of Conflict of Laws § 268, comment *h* (1971):

The question of the allocation of receipts and expenditures to principal or income presents a different problem. See Restatement (Second) of Trusts, §§ 232-241 (1959). If a testator creates a trust to be administered in a state other than that of his domicile, the question is whether the allocation, as for instance of extraordinary dividends, is to be determined by the local law of his domicile or the local law of the place of administration. This could conceivably be treated as a question of administration and governed by the local law of the place of administration. On the other hand, it can be treated as a question of the distribution of the trust property and governed by the local law of the testator's domicile. For the purposes of the choice of the applicable law, it is generally held that it is a question of construction and that the local law of the testator's domicile is applicable.

Despite the fact that income and principal allocations often do determine who gets what and therefore are rules of construction, treating those allocations as governed by the place of current administration seems to be the most workable approach and seems to be contemplated, for example, by the change-of-situs examples in the 2003 amendments to the GST tax regulations (Treasury Reg. §26.2601-1(b)(4)(i)(E), Examples 11 & 12). Perhaps the biggest burden of a rule of construction is determining the governing law not only *where* the trust was originally created but also *when* the trust was originally created, a burden that gets greater as longer-term trusts become more common and existing trusts therefore become older. Previous Uniform Principal and Income Acts did not include a governing law provision. New Section 104 of the 2018 Act specifies that the Uniform Fiduciary Income and Principal Act, like a rule of administration, is governed by the law of the situs, or principal place of administration, of the trust, which is not necessarily the place where all or most or any of the trust assets are located.

Section 104 is consistent with Sections 107 and 108 of the Uniform Trust Code and Section 3 of the Uniform Directed Trust Act. Like those acts, the rule of Section 104 may be superseded by a provision in the terms of the trust.

UNIFORM FIDUCIARY INCOME AND PRINCIPAL ACT

[ARTICLE] 1

GENERAL PROVISIONS

SECTION 101. SHORT TITLE. This act may be cited as the Uniform Fiduciary Income and Principal Act.

Comment

Name. The change in the name of this Uniform Act has three purposes and effects.

First, this name will distinguish the 2018 Act from its 1931, 1962, and 1997 predecessors and support an acronym that will not be confused with the Uniform Prudent Investor Act, which was closely associated with the 1997 Revised Uniform Principal and Income Act.

Second, by using the word “Fiduciary,” the name emphasizes that the distinctions between income and principal are most likely to be relevant in the context of trusts and decedents’ estates, especially trusts that continue for a long time, perpetually in the case of some modern trusts. Such trusts present a greater possibility of competing interests between those entitled to income currently and those who may be entitled to income and/or principal – that is, entitled to “what’s left” – after the current interests terminate by death or otherwise. The act also applies to term relationships other than just trusts and decedents’ estates, such as legal life estates, which may share the long-term character and need for balancing of successive interests that is most commonly associated with trusts. But the primary applications of the act will generally be in contexts marked by the role of a fiduciary.

Third, placing income first in the name emphasizes the fact that principal may be “what’s left” after income is paid out. After income is paid out it is gone and normally cannot be retrieved (although prior over-distributions can sometimes be taken into account in determining the amount of future distributions). This continues the practice of previous acts of favoring principal where there is uncertainty.

SECTION 102. DEFINITIONS. In this act:

(1) “Accounting period” means a calendar year, unless a fiduciary selects another period of 12 calendar months or approximately 12 calendar months. The term includes a part of a calendar year or another period of 12 calendar months or approximately 12 calendar months which begins when an income interest begins or ends when an income interest ends.

(2) “Asset-backed security” means a security that is serviced primarily by the cash flows

of a discrete pool of fixed or revolving receivables or other financial assets that by their terms convert into cash within a finite time. The term includes rights or other assets that ensure the servicing or timely distribution of proceeds to the holder of the asset-backed security. The term does not include an asset to which Section 401, 409, or 414 applies.

(3) "Beneficiary" includes:

(A) for a trust:

(i) a current beneficiary, including a current income beneficiary and a beneficiary that may receive only principal;

(ii) a remainder beneficiary; and

(iii) any other successor beneficiary;

(B) for an estate, an heir[, legatee,] and devisee; and

(C) for a life estate or term interest, a person that holds a life estate, term interest, or remainder or other interest following a life estate or term interest.

(4) "Court" means the district court [~~the court in this state having jurisdiction relating to a trust, estate, or life estate or other term interest described in Section 103(2)~~].

(5) "Current income beneficiary" means a beneficiary to which a fiduciary may distribute net income, whether or not the fiduciary also may distribute principal to the beneficiary.

(6) "Distribution" means a payment or transfer by a fiduciary to a beneficiary in the beneficiary's capacity as a beneficiary, made under the terms of the trust, without consideration other than the beneficiary's right to receive the payment or transfer under the terms of the trust. "Distribute", "distributed", and "distributee" have corresponding meanings.

(7) "Estate" means a decedent's estate. The term includes the property of the decedent as the estate is originally constituted and the property of the estate as it exists at any time during

administration.

(8) "Fiduciary" includes a trustee, person holding a power to direct and presumptively serving as a fiduciary under K.S.A. 58a-808, and amendments thereto, ~~trust director determined under [Section 2(9) of the Uniform Directed Trust Act,]]~~ personal representative, life tenant, holder of a term interest, and person acting under a delegation from a fiduciary. The term includes a person that holds property for a successor beneficiary whose interest may be affected by an allocation of receipts and expenditures between income and principal. If there are two or more co-fiduciaries, the term includes all co-fiduciaries acting under the terms of the trust and applicable law.

(9) "Income" means money or other property a fiduciary receives as current return from principal. The term includes a part of receipts from a sale, exchange, or liquidation of a principal asset, to the extent provided in [Article] 4.

(10) "Income interest" means the right of a current income beneficiary to receive all or part of net income, whether the terms of the trust require the net income to be distributed or authorize the net income to be distributed in the fiduciary's discretion. The term includes the right of a current beneficiary to use property held by a fiduciary.

(11) "Independent person" means a person that is not:

(A) for a trust:

(i) fa qualified beneficiary determined under K.S.A. 58a-103(12), and amendments thereto, ~~[Uniform Trust Code Section 103(13)]~~ ~~[[a beneficiary that is a distributee or permissible distributee of trust income or principal or would be a distributee or permissible distributee of trust income or principal if either the trust or the interests of the distributees or permissible distributees of trust income or principal were terminated, assuming no power of~~

appointment is exercised];

(ii) a settlor of the trust; or

(iii) an individual whose legal obligation to support a beneficiary may be satisfied by a distribution from the trust;

(B) for an estate, a beneficiary;

(C) a spouse, parent, brother, sister, or issue of an individual described in subparagraph (A) or (B);

(D) a corporation, partnership, limited liability company, or other entity in which persons described in subparagraphs (A) through (C), in the aggregate, have voting control; or

(E) an employee of a person described in subparagraph (A), (B), (C), or (D).

(12) "Mandatory income interest" means the right of a current income beneficiary to receive net income that the terms of the trust require the fiduciary to distribute.

(13) "Net income" means the total allocations during an accounting period to income under the terms of a trust and this act minus the disbursements during the period, other than distributions, allocated to income under the terms of the trust and this act. To the extent the trust is a unitrust under [Article] 3, the term means the unitrust amount determined under [Article] 3. The term includes an adjustment from principal to income under Section 203. The term does not include an adjustment from income to principal under Section 203.

(14) "Person" means an individual, estate, trust, business or nonprofit entity, public corporation, government or governmental subdivision, agency, or instrumentality, or other legal entity.

(15) "Personal representative" means an executor, administrator, successor personal representative, special administrator, or person that performs substantially the same function with

respect to an estate under the law governing the person's status.

(16) "Principal" means property held in trust for distribution to, production of income for, or use by a current or successor beneficiary.

(17) "Record" means information that is inscribed on a tangible medium or that is stored in an electronic or other medium and is retrievable in perceivable form.

(18) "Settlor" means a person, including a testator, that creates or contributes property to a trust. If more than one person creates or contributes property to a trust, the term includes each person, to the extent of the trust property attributable to that person's contribution, except to the extent another person has the power to revoke or withdraw that portion.

(19) "Special tax benefit" means:

(A) exclusion of a transfer to a trust from gifts described in Section 2503(b) of the Internal Revenue Code of 1986~~[, as amended,]~~, 26 U.S.C. Section 2503(b)~~[, as amended,]~~, because of the qualification of an income interest in the trust as a present interest in property;

(B) status as a qualified subchapter S trust described in Section 1361(d)(3) of the Internal Revenue Code of 1986~~[, as amended,]~~, 26 U.S.C. Section 1361(d)(3)~~[, as amended,]~~, at a time the trust holds stock of an S corporation described in Section 1361(a)(1) of the Internal Revenue Code of 1986~~[, as amended,]~~, 26 U.S.C. Section 1361(a)(1)~~[, as amended,]~~;

(C) an estate or gift tax marital deduction for a transfer to a trust under Section 2056 or 2523 of the Internal Revenue Code of 1986~~[, as amended,]~~, 26 U.S.C. Section 2056 or 2523~~[, as amended,]~~, which depends or depended in whole or in part on the right of the settlor's spouse to receive the net income of the trust;

(D) exemption in whole or in part of a trust from the federal generation-skipping transfer tax imposed by Section 2601 of the Internal Revenue Code of 1986~~[, as amended,]~~, 26

U.S.C. Section 2601~~[, as amended,]~~, because the trust was irrevocable on September 25, 1985, if there is any possibility that:

(i) a taxable distribution, as defined in Section 2612(b) of the Internal Revenue Code of 1986~~[, as amended,]~~, 26 U.S.C. Section 2612(b)~~[, as amended,]~~, could be made from the trust; or

(ii) a taxable termination, as defined in Section 2612(a) of the Internal Revenue Code of 1986~~[, as amended,]~~, 26 U.S.C. Section 2612(a)~~[, as amended,]~~, could occur with respect to the trust; or

(E) an inclusion ratio, as defined in Section 2642(a) of the Internal Revenue Code of 1986~~[, as amended,]~~, 26 U.S.C. Section 2642(a)~~[, as amended,]~~, of the trust which is less than one, if there is any possibility that:

(i) a taxable distribution, as defined in Section 2612(b) of the Internal Revenue Code of 1986~~[, as amended,]~~, 26 U.S.C. Section 2612(b)~~[, as amended,]~~, could be made from the trust; or

(ii) a taxable termination, as defined in Section 2612(a) of the Internal Revenue Code of 1986~~[, as amended,]~~, 26 U.S.C. Section 2612(a)~~[, as amended,]~~, could occur with respect to the trust.

(20) "Successive interest" means the interest of a successor beneficiary.

(21) "Successor beneficiary" means a person entitled to receive income or principal or to use property when an income interest or other current interest ends.

(22) "Terms of a trust" means:

(A) except as otherwise provided in subparagraph (B), the manifestation of the settlor's intent regarding a trust's provisions as:

(i) expressed in the trust instrument; or

(ii) established by other evidence that would be admissible in a judicial

proceeding;

(B) the trust's provisions as established, determined, or amended by:

(i) a trustee or ~~trust director~~ person holding a power to direct under K.S.A.

58a-808, and amendments thereto, in accordance with applicable law; [or]

(ii) court order~~;~~; or

(iii) a nonjudicial settlement agreement under K.S.A. 58a-111, and

amendments thereto [Uniform Trust Code Section 111]];

(C) for an estate, a will; or

(D) for a life estate or term interest, the corresponding manifestation of the rights

of the beneficiaries.

(23) "Trust":

(A) includes:

(i) an express trust, private or charitable, with additions to the trust,

wherever and however created; and

(ii) a trust created or determined by judgment or decree under which the

trust is to be administered in the manner of an express trust; and

(B) does not include:

(i) a constructive trust;

(ii) a resulting trust, conservatorship, guardianship, multi-party account,

custodial arrangement for a minor, business trust, voting trust, security arrangement, liquidation

trust, or trust for the primary purpose of paying debts, dividends, interest, salaries, wages, profits,

pensions, retirement benefits, or employee benefits of any kind; or

(iii) an arrangement under which a person is a nominee, escrowee, or agent for another.

(24) “Trustee” means a person, other than a personal representative, that owns or holds property for the benefit of a beneficiary. The term includes an original, additional, or successor trustee, whether or not appointed or confirmed by a court.

(25) “Will” means any testamentary instrument recognized by applicable law which makes a legally effective disposition of an individual’s property, effective at the individual’s death. The term includes a codicil or other amendment to a testamentary instrument.

Legislative Note: *Revise paragraph (4) as necessary to refer to the appropriate court having jurisdiction over the matters listed.*

In paragraph (8), refer to Uniform Directed Trust Act Section 2(9), or modify paragraph (8) appropriately if the state has not enacted the Uniform Directed Trust Act.

In paragraph (11)(A)(i), refer to Uniform Trust Code Section 103(13), or modify paragraph (11)(A)(i) appropriately if the state has not enacted the Uniform Trust Code.

A state that has enacted Uniform Trust Code Section 103(15) and (20) may replace paragraphs (18) and (24) with cross-references to those provisions.

A United States Code citation (U.S.C.) follows a reference to the federal Internal Revenue Code in paragraph (19). The United States Code citation is included as an aid to the reader. If the state’s convention is to omit the United States Code citation, simply delete the United States Code citation. In states in which the constitution, or other law, does not permit the phrase “as amended” when federal statutes are incorporated into state law, the phrase should be omitted from paragraph (19).

A state that has enacted Uniform Trust Code (Last Revised or Amended in 2010) Section 103(18), defining “terms of a trust”, or the Uniform Trust Decanting Act (2015) Section 2(28), defining “terms of the trust”, should update those definitions to conform to paragraph (22)(A) and (B). A state that has not enacted Uniform Trust Code Section 111 should replace the bracketed language of paragraph (22)(B)(iii) with a cross reference to the state’s statute governing nonjudicial settlement or should omit paragraph (22)(B)(iii) if the state does not have such a statute.

Comment

“Accounting period.” The 2018 Act adds the option of using an accounting period of “approximately 12 calendar months.” This clarifies that a 52-53-week fiscal year contemplated, for example, by section 441(f) of the Internal Revenue Code of 1986, or any other reasonable fiscal year, is not precluded.

“Beneficiary.” The 2018 Act expands the definition to include life estate-remainder relationships, as provided in the broader scope of the act set forth in Section 103. The definition is adapted to the context of income and principal allocations.

“Court.” The 2018 Act defines “court,” to simplify references throughout the act. The definition is drawn from Section 2(8) of the Uniform Trust Decanting Act and conformed to the broader scope in Section 103 of this act.

“Current income beneficiary,” “income interest,” and “mandatory income interest.” The 2018 Act adds these definitions because of their relevance to the temporal distinctions between income and principal. There are no definitions for “discretionary income beneficiary” or “discretionary income interest” because those terms are not used in the act.

“Distribution,” “distribute,” “distributed,” and “distributee.” The 2018 Act adds this definition, which clarifies that these words are used in the limited sense of a payment or transfer to a beneficiary only in the beneficiary’s capacity as beneficiary with respect to that beneficiary’s interest in the trust. For example, these words do not include compensation paid to a beneficiary who is also a fiduciary or employee, rent paid to a beneficiary who leases property to a trust, or interest paid to a beneficiary who has made a loan or installment sale to a trust.

“Fiduciary.” The 2018 Act expands this definition to conform to the broader scope in Section 103. The definition makes it clear that the singular “fiduciary” will be used throughout the act even when two or more fiduciaries are serving together at the same time. To refer to one or more but not all of the fiduciaries serving at the same time that are authorized to exercise the power to adjust under Section 203 or disregard insubstantial allocations under Section 408 when one or more of the other then-serving fiduciaries are not authorized to do so, Sections 203 and 408 use the variations “co-fiduciary” and “co-fiduciaries”. The term “fiduciary” does not refer to successor fiduciaries or potential successor fiduciaries that are not then serving.

“Independent person.” The 2018 Act adds a definition of an “independent person,” which is used in Sections 203(e)(7), 309(b), and 501(2) with reference to fiduciaries to limit certain fiduciary discretionary powers to independent fiduciaries. Because an important reason for these limitations is to protect against unwelcome tax consequences, the definition in large part reflects, in the negative, the definition of a “related or subordinate party” in section 672(c) of the Internal Revenue Code of 1986, which is incorporated by some tax rules, some safe harbors acknowledged by the IRS, and some conventions of document drafting. A limited liability company is added to subparagraph (D). Otherwise, subparagraphs (B) through (E) track section 672(c) as closely as feasible. For example, subparagraph (D) refers simply to “voting control” rather than the more subjective “significant from the viewpoint of voting control” used in section 672(c)(2), and subparagraph (E) refers simply to “an employee” rather than the more subjective “subordinate employee” used in reference to a corporation in section 672(c)(2). Subparagraph (C) refers to a “spouse,” as does section 672(c)(1); in view of the evolution of the law in this

area, no reference has been included to “domestic partners” or similar terms. Although this definition largely tracks the definition of a “related or subordinate party” in section 672(c) of the Internal Revenue Code of 1986, its purposes in the act are broader than the protection of tax benefits, and it therefore is broader than section 672(c) in some respects.

“Net income.” “Net income” continues to be the term generally used in the 2018 Act to refer to what a current beneficiary must or may receive. This use is flexible enough to cover, for example, even a trust, or a special circumstance related to a trust, that requires or permits distributions of gross income, because “net income” *is* gross income (expressed as “the total allocations during an accounting period to income under the terms of a trust and this [act]”) “minus the disbursements during the period, other than distributions, allocated to income under the terms of the trust and this [act].” To the extent the terms of a trust require or permit the distribution of gross income, there will necessarily be no “disbursements ... allocated to income” – all such disbursement will necessarily be allocated to principal – and thus the definition will work even in that unusual case. In addition, the 2018 Act expands this definition to explicitly provide that in a unitrust, now provided for in new Article 3, “net income” *is* the unitrust amount, without deduction for any disbursements.

“Record.” This addition in the 2018 Act is copied from Section 2(22) of the Uniform Trust Decanting Act.

“Settlor.” The 2018 Act adds a definition of “settlor” adapted from Section 103(15) of the Uniform Trust Code and Section 2(6) of the recent Uniform Directed Trust Act. It includes a “testator.” Because of this definition, there is generally no reason to add words like “testator,” “donor,” or “transferor” throughout this act.

“Special tax benefit.” In exercising various forms of fiduciary discretion under the 2018 Act, there are certain federal tax benefits that it is important to preserve and certain adverse federal tax consequences that it is important to avoid. (Section 104(c) of the 1997 Act served that purpose with respect to the power to adjust between income and principal.) There are four kinds of “special tax benefit” that it is important to preserve under the 2018 Act that are defined in Section 102(19). One is the qualification of an income interest in a trust for the annual exclusion from taxable gifts because the income interest is a “present interest” in property under Treasury Reg. §25.2503-3(b) and therefore is not a “future interest in property” referred to in section 2503(b)(1) of the Internal Revenue Code of 1986 (subparagraph (A) of this act). Another is the eligibility of a trust to hold stock of an S corporation under section 1361 as a “qualified subchapter S trust” (QSST) under section 1361(d) of the Code if all of the income is distributed to one citizen or resident of the United States under section 1361(d)(3)(B) of the Code (subparagraph (B)). Another is the eligibility of a transfer to a trust for an estate or gift tax marital deduction because the settlor’s spouse is entitled to all the net income of the trust under section 2056(b)(5) or (7)(B)(i)(II) or 2523(e) or (f)(2)(B) of the Code (subparagraph (C)). Finally, there is the total or partial exemption of a trust from generation-skipping transfer tax (GST tax) either under section 1433(b)(2)(A) of the Tax Reform Act of 1986 (Public Law 99-514) because the trust was irrevocable on September 25, 1985 (subparagraph (D)) or under section 2642(a)(2)(A) of the Code because GST exemption was allocated to the trust (subparagraph (E)). This definition of a “special tax benefit” is used to determine limits on the power to adjust between income and principal under Section 203(e)(1) and the new power to

convert to or from a unitrust or change a unitrust under Section 309(b).

“Successor beneficiary.” This term is used in the 2018 Act rather than “remainder beneficiary,” the term in the 1997 Act, in recognition of the fact that modern trusts often last longer than the life of a single income beneficiary, and therefore the beneficiaries whose future interests are most often in need of balance and protection are beneficiaries who continue as income beneficiaries, not who succeed to the “remainder” interest as if the trust terminates. The term “successor beneficiary” includes remainder beneficiaries.

“Terms of a trust.” The definition of “terms of a trust” in the 2018 Act is conformed to Section 2(8) of the Uniform Directed Trust Act, which is similar to Section 2(28) of the Uniform Trust Decanting Act and Section 103(18) of the Uniform Trust Code. This replaces Section 102(12) of the 1997 Act, which reads: “‘Terms of a trust’ means the manifestation of the intent of a settlor or decedent with respect to a trust, expressed in a manner that admits of its proof in a judicial proceeding, whether by written or spoken words or by conduct.” Subparagraphs (C) and (D) are added to conform to the broader scope in Section 103. The expressions “terms of *a* trust” and “terms of *the* trust” are used interchangeably in the act, depending on whether there has been a reference to a trust, either explicitly or indirectly, previously in the subsection (or self-contained paragraph).

SECTION 103. SCOPE. Except as otherwise provided in the terms of a trust or this act, this act applies to:

(1) a trust or estate; and

(2) a life estate or other term interest in which the interest of one or more persons will be succeeded by the interest of one or more other persons.

SECTION 104. GOVERNING LAW. Except as otherwise provided in the terms of a trust or this act, this act applies when this state is the principal place of administration of a trust or estate or the situs of property that is not held in a trust or estate and is subject to a life estate or other term interest described in Section 103(2). By accepting the trusteeship of a trust having its principal place of administration in this state or by moving the principal place of administration of a trust to this state, the trustee submits to the application of this [act] to any matter within the scope of this act involving the trust.

Comment

As explained in the Prefatory Note, new Section 104 of the 2018 Act specifies that the

Uniform Fiduciary Income and Principal Act is governed by the law of the situs, or principal place of administration, of the trust. This is consistent with Sections 107 and 108 of the Uniform Trust Code and Section 3 of the Uniform Directed Trust Act. Like those acts, the rule of Section 104 may be superseded by a provision in the terms of the trust.

[ARTICLE] 2

FIDUCIARY DUTIES AND JUDICIAL REVIEW

SECTION 201. FIDUCIARY DUTIES; GENERAL PRINCIPLES.

(a) In making an allocation or determination or exercising discretion under this act, a fiduciary shall:

- (1) act in good faith, based on what is fair and reasonable to all beneficiaries;
- (2) administer a trust or estate impartially, except to the extent the terms of the trust manifest an intent that the fiduciary shall or may favor one or more beneficiaries;
- (3) administer the trust or estate in accordance with the terms of the trust, even if there is a different provision in this act; and
- (4) administer the trust or estate in accordance with this act, except to the extent the terms of the trust provide otherwise or authorize the fiduciary to determine otherwise.

(b) A fiduciary's allocation, determination, or exercise of discretion under this act is presumed to be fair and reasonable to all beneficiaries. A fiduciary may exercise a discretionary power of administration given to the fiduciary by the terms of the trust, and an exercise of the power which produces a result different from a result required or permitted by this act does not create an inference that the fiduciary abused the fiduciary's discretion.

(c) A fiduciary shall:

- (1) add a receipt to principal, to the extent neither the terms of the trust nor this act allocates the receipt between income and principal; and
- (2) charge a disbursement to principal, to the extent neither the terms of the trust

nor this act allocates the disbursement between income and principal.

(d) A fiduciary may exercise the power to adjust under Section 203, convert an income trust to a unitrust under Section 303(a)(1), change the percentage or method used to calculate a unitrust amount under Section 303(a)(2), or convert a unitrust to an income trust under Section 303(a)(3), if the fiduciary determines the exercise of the power will assist the fiduciary to administer the trust or estate impartially.

(e) Factors the fiduciary must consider in making the determination under subsection (d) include:

- (1) the terms of the trust;
- (2) the nature, distribution standards, and expected duration of the trust;
- (3) the effect of the allocation rules, including specific adjustments between income and principal, under [Articles] 4 through 7;
- (4) the desirability of liquidity and regularity of income;
- (5) the desirability of the preservation and appreciation of principal;
- (6) the extent to which an asset is used or may be used by a beneficiary;
- (7) the increase or decrease in the value of principal assets, reasonably determined by the fiduciary;
- (8) whether and to what extent the terms of the trust give the fiduciary power to accumulate income or invade principal or prohibit the fiduciary from accumulating income or invading principal;
- (9) the extent to which the fiduciary has accumulated income or invaded principal in preceding accounting periods;
- (10) the effect of current and reasonably expected economic conditions; and

(11) the reasonably expected tax consequences of the exercise of the power.

Comment

Subsections (a) through (c) of Section 201 of the 2018 Act are an update of Section 103 of the 1997 Act.

The standard of what is fair and reasonable to all beneficiaries in subsection (a)(1) is derived from Section 103(b) of the 1997 Act; it is an objective standard, not dependent on what *seems* to any beneficiary to be fair and reasonable. A requirement to act “in good faith” is added, complementing and supporting the exoneration for a fiduciary’s action or inaction in good faith in Sections 203(c) (relating to the power to adjust between income and principal) and 302(f) (relating to the new power to convert to or from a unitrust or change a unitrust) of the 2018 Act.

The requirement to administer a trust or estate impartially in subsection (a)(2) is also derived from Section 103(b) of the 1997 Act, as is the accompanying exception to the extent the terms of the trust manifest an intent to favor one or more beneficiaries.

The terms of the trust may alter the degree or nature of impartiality without abandoning the duty of impartiality. For example, the terms of the trust may permit or require a current beneficiary to be preferred to meet needs for support in accordance with an accustomed standard of living and for medical care, but in making determinations regarding that standard the trustee owes a duty of impartiality to the current beneficiary and the successor beneficiaries. If such a preference for support and health is expressed, the 2018 Act preserves the duty of impartiality in making discretionary distributions when that standard is satisfied.

The fact that an income beneficiary or a remainder beneficiary is also the fiduciary is not by itself an indication of partiality for that beneficiary.

Like previous acts, the 2018 Act contains only default rules. The general supremacy of the terms of the trust is affirmed in subsection (a)(3), as in Section 103(a)(1) of the 1997 Act. Conversely, the applicability of the act where not overridden by the terms of the trust is affirmed in subsection (a)(4), but in a simpler and clearer way than Section 103(a)(3) of the 1997 Act, which stated that “a fiduciary ... shall administer a trust or estate in accordance with this [Act] *if the terms of the trust or the will do not contain a different provision or do not give the fiduciary a discretionary power of administration.*” The 2018 Act states simply “except to the extent the terms of the trust provide otherwise or authorize the fiduciary to determine otherwise.”

The presumption of fairness and reasonableness of a fiduciary’s determination in the first sentence of subsection (b) is adapted from the last sentence of Section 103(b) of the 1997 Act. The reassurance in the following sentence of subsection (b) that a result of a fiduciary’s exercise of discretion under the terms of the trust that is different from a result under the act does not create a negative inference is adapted from Section 103(a)(2) of the 1997 Act.

The default of adding a receipt, or charging a disbursement, to principal in subsection (c) is derived from Section 103(a)(4) of the 1997 Act.

Factors. The factors in subsection (e) that a fiduciary must consider are adapted from Section 104(b) of the 1997 Act, which was written in the context of the power to adjust between income and principal now found in Section 203. Unlike Section 104(b) of the 1997 Act, subsection (e) does not limit such consideration to those factors “to the extent they are relevant,” because determining that a factor is not relevant would itself require a degree of consideration. Under subsection (d), those factors are now also applicable to the new power to convert to or from a unitrust or change a unitrust granted by Section 303.

“The terms of the trust” are added as an obvious factor and, indeed, placed first, in paragraph (1). Correspondingly, in paragraph (2) the “purpose” of the trust is deleted as a factor, as is “the intent of the settlor” in Section 104(b)(2) of the 1997 Act. Divining or guessing subjective elements like “purpose” and “intent” are not a reasonable burden to place on a fiduciary, whereas “terms of the trust” is defined in Section 102(22)(A) to be “the *manifestation* of the settlor’s intent” in an objective medium.

Paragraph (3) adds “the effect of the allocation rules, including specific adjustments between income and principal, under [Articles] 4 through 7,” an elaboration of the reference to “the other sections of this [Act]” in Section 104(b)(6) of the 1997 Act. This wording affirms that a main function of the power to adjust or to convert to a unitrust is to fix or compensate for the results otherwise obtained under those default rules. And because the filter of the default rules in Articles 4 through 7 is the meaningful way to view the assets of the trust, the enumeration of a few characteristics of those assets in Section 104(b)(5) of the 1997 Act is omitted, except for the use of an asset by a beneficiary, which is retained in paragraph (6).

In paragraphs (4) and (5), “the needs for liquidity, regularity of income, and preservation and appreciation of capital” (as expressed in Section 104(b)(4) of the 1997 Act) is retained, except that “needs for” is changed to “desirability of” and “capital” is changed to “principal.”

Paragraph (7) retains “the increase or decrease in the value of principal assets” from Section 104(b)(6) of the 1997 Act. The volatility of value, as well as the unpredictability of income, can be an occasion for the “smoothing” the powers to adjust between income and principal and to convert to or from a unitrust or change a unitrust are designed to provide.

Finally, “the actual and anticipated effect of economic conditions on principal and income and effects of inflation and deflation” in Section 104(b)(8) of the 1997 Act is simplified to “the effect of current and reasonably expected economic conditions” in paragraph (10), and “anticipated tax consequences” in Section 104(b)(9) of the 1997 Act is changed to “reasonably expected tax consequences” in paragraph (11).

SECTION 202. JUDICIAL REVIEW OF EXERCISE OF DISCRETIONARY

POWER; REQUEST FOR INSTRUCTION.

(a) In this section, “fiduciary decision” means:

(1) a fiduciary’s allocation between income and principal or other determination

regarding income and principal required or authorized by the terms of the trust or this act;

(2) the fiduciary's exercise or nonexercise of a discretionary power regarding income and principal granted by the terms of the trust or this act, including the power to adjust under Section 203, convert an income trust to a unitrust under Section 303(a)(1), change the percentage or method used to calculate a unitrust amount under Section 303(a)(2), or convert a unitrust to an income trust under Section 303(a)(3); or

(3) the fiduciary's implementation of a decision described in paragraph (1) or (2).

(b) The court may not order a fiduciary to change a fiduciary decision unless the court determines that the fiduciary decision was an abuse of the fiduciary's discretion.

(c) If the court determines that a fiduciary decision was an abuse of the fiduciary's discretion, the court may order a remedy authorized by law[, including K.S.A. 58a-1001, and amendments thereto, Uniform Trust Code Section 1001]. To place the beneficiaries in the positions the beneficiaries would have occupied if there had not been an abuse of the fiduciary's discretion, the court may order:

(1) the fiduciary to exercise or refrain from exercising the power to adjust under Section 203;

(2) the fiduciary to exercise or refrain from exercising the power to convert an income trust to a unitrust under Section 303(a)(1), change the percentage or method used to calculate a unitrust amount under Section 303(a)(2), or convert a unitrust to an income trust under Section 303(a)(3);

(3) the fiduciary to distribute an amount to a beneficiary;

(4) a beneficiary to return some or all of a distribution; or

(5) the fiduciary to withhold an amount from one or more future distributions to a

beneficiary.

{(d) On {petition} by a fiduciary for instruction, the court may determine whether a proposed fiduciary decision will result in an abuse of the fiduciary's discretion. If the {petition} describes the proposed decision, contains sufficient information to inform the beneficiary of the reasons for making the proposed decision and the facts on which the fiduciary relies, and explains how the beneficiary will be affected by the proposed decision, a beneficiary that opposes the proposed decision has the burden to establish that it will result in an abuse of the fiduciary's discretion. If a fiduciary chooses not to seek court instruction about a proposed decision under this subsection, that choice shall not constitute evidence that the fiduciary's decision was an abuse of discretion.}

Legislative Note: *In subsection (c), refer to Uniform Trust Code Section 1001, or modify subsection (c) appropriately or refer to the corresponding provision of the state's trust law if the state has not enacted the Uniform Trust Code.*

Modify subsection (d) if the manner for bringing the matter to a court under the state law is not a "petition", or delete subsection (d) and modify the title to the section if the state law does not permit a court to give instruction to a fiduciary in these circumstances.

Comment

Section 202 of the 2018 Act is adapted from Section 105 of the 1997 Act. Subsection (a) expands the scope of Section 105(b) of the 1997 Act from the power to adjust to include not only the powers under the new unitrust provisions (subsection (a)(2)) but also any allocation or other determination regarding income and principal (subsection (a)(1)) and the implementation of any such allocations, determinations, or actions (subsection (a)(3)). Collectively these decisions are called "fiduciary decisions."

Subsection (b) retains the general rule of Section 105(a) of the 1997 Act that a court will intervene only if it determines that the fiduciary decision was an abuse of the fiduciary's discretion. The statement that "A fiduciary's decision is not an abuse of discretion merely because the court would have exercised the power in a different manner or would not have exercised the power," although obviously true, is deleted as unnecessary. *See* Restatement (Third) of Trusts § 50, comment *b* (2003) ("A court will not interfere with a trustee's exercise of a discretionary power when that exercise is reasonable and not based on an improper interpretation of the terms of the trust. Thus, judicial intervention is not warranted merely because the court would have differently exercised the discretion.").

Subsection (c) focuses the enumeration of available remedies on remedies that place the beneficiaries overtly – and the trust implicitly – “in the positions [they] would have occupied if there had not been an abuse of the fiduciary’s discretion,” while acknowledging that the choice of remedy is of course the court’s decision to make. Paragraphs (1) and (2) add that the court may simply order that the fiduciary exercise or refrain from exercising the power to adjust or the power to convert to or from a unitrust or change a unitrust. Those remedies are placed first because they may often be the first choices (but, again, without purporting to limit the court’s authority). Paragraphs (3), (4), and (5) contain the remedies of ordering a distribution or withholding from future distributions by a fiduciary or even ordering a refund by a beneficiary.

The remedy in Section 105(c)(3) of the 1997 Act of ordering the fiduciary to use the fiduciary’s own funds to make a beneficiary whole is deleted – not denied to a court, but deleted as beyond the scope of a statute dealing primarily with allocations of income and principal. But the fiduciary’s option of obtaining advance directions from the court (in Section 105(d) of the 1997 Act) is retained in subsection (d), if consistent with general state law. The reference in Section 105 of the 1997 Act to “the court having jurisdiction of a trust or estate” is shortened to just “the court,” which is defined in Section 102(4).

SECTION 203. FIDUCIARY’S POWER TO ADJUST.

(a) Except as otherwise provided in the terms of a trust or this section, a fiduciary, in a record, without court approval, may adjust between income and principal if the fiduciary determines the exercise of the power to adjust will assist the fiduciary to administer the trust or estate impartially.

(b) This section does not create a duty to exercise or consider the power to adjust under subsection (a) or to inform a beneficiary about the applicability of this section.

(c) A fiduciary that in good faith exercises or fails to exercise the power to adjust under subsection (a) is not liable to a person affected by the exercise or failure to exercise.

(d) In deciding whether and to what extent to exercise the power to adjust under subsection (a), a fiduciary shall consider all factors the fiduciary considers relevant, including relevant factors in Section 201(e) and the application of Sections 401(i), 408, and 413.

(e) A fiduciary may not exercise the power under subsection (a) to make an adjustment or under Section 408 to make a determination that an allocation is insubstantial if:

(1) the adjustment or determination would reduce the amount payable to a current

income beneficiary from a trust that qualifies for a special tax benefit, except to the extent the adjustment is made to provide for a reasonable apportionment of the total return of the trust between the current income beneficiary and successor beneficiaries;

(2) the adjustment or determination would change the amount payable to a beneficiary, as a fixed annuity or a fixed fraction of the value of the trust assets, under the terms of the trust;

(3) the adjustment or determination would reduce an amount that is permanently set aside for a charitable purpose under the terms of the trust, unless both income and principal are set aside for the charitable purpose;

(4) possessing or exercising the power would cause a person to be treated as the owner of all or part of the trust for federal income tax purposes;

(5) possessing or exercising the power would cause all or part of the value of the trust assets to be included in the gross estate of an individual for federal estate tax purposes;

(6) possessing or exercising the power would cause an individual to be treated as making a gift for federal gift tax purposes;

(7) the fiduciary is not an independent person;

(8) the trust is irrevocable and provides for income to be paid to the settlor and possessing or exercising the power would cause the adjusted principal or income to be considered an available resource or available income under a public-benefit program; or

(9) the trust is a unitrust under [Article] 3.

(f) If subsection (e)(4), (5), (6), or (7) applies to a fiduciary:

(1) a co-fiduciary to which subsection (e)(4) through (7) does not apply may exercise the power to adjust, unless the exercise of the power by the remaining co-fiduciary or

co-fiduciaries is not permitted by the terms of the trust or law other than this act; or

(2) if there is no co-fiduciary to which subsection (e)(4) through (7) does not apply, the fiduciary may appoint a co-fiduciary to which subsection (e)(4) through (7) does not apply, which may be a special fiduciary with limited powers, and the appointed co-fiduciary may exercise the power to adjust under subsection (a), unless the appointment of a co-fiduciary or the exercise of the power by a co-fiduciary is not permitted by the terms of the trust or law other than this act.

(g) A fiduciary may release or delegate to a co-fiduciary the power to adjust under subsection (a) if the fiduciary determines that the fiduciary's possession or exercise of the power will or may:

(1) cause a result described in subsection (e)(1) through (6) or (8); or

(2) deprive the trust of a tax benefit or impose a tax burden not described in subsection (e)(1) through (6).

(h) A fiduciary's release or delegation to a co-fiduciary under subsection (g) of the power to adjust under subsection (a):

(1) must be in a record;

(2) applies to the entire power, unless the release or delegation provides a limitation, which may be a limitation to the power to adjust:

(A) from income to principal;

(B) from principal to income;

(C) for specified property; or

(D) in specified circumstances;

(3) for a delegation, may be modified by a re-delegation under this subsection by

the co-fiduciary to which the delegation is made; and

(4) subject to paragraph (3), is permanent, unless the release or delegation provides a specified period, including a period measured by the life of an individual or the lives of more than one individual.

(i) Terms of a trust which deny or limit the power to adjust between income and principal do not affect the application of this section, unless the terms of the trust expressly deny or limit the power to adjust under subsection (a).

(j) The exercise of the power to adjust under subsection (a) in any accounting period may apply to the current period, the immediately preceding period, and one or more subsequent periods.

(k) A description of the exercise of the power to adjust under subsection (a) must be:

(1) included in a report, if any, sent to beneficiaries under K.S.A. 58a-813, and amendments thereto, ~~[Uniform Trust Code Section 813(e)]~~; or

(2) communicated at least annually to ~~[the qualified beneficiaries determined under K.S.A. 58a-103(12), and amendments thereto, ~~[Uniform Trust Code Section 103(13)]~~, other than [the Attorney General]]~~~~[all beneficiaries that receive or are entitled to receive income from the trust or would be entitled to receive a distribution of principal if the trust were terminated at the time the notice is sent, assuming no power of appointment is exercised]~~.

Legislative Note: Delete or modify subsection (f) if the state law requires fiduciaries to act unanimously.

In subsection (k), refer to Uniform Trust Code Sections 813(c) and 103(13), or modify subsection (k) appropriately or refer to the corresponding provision of the state's trust law if the state has not enacted the Uniform Trust Code.

Comment

Origin, purpose, and scope of the power to adjust. The power to adjust between income and principal was added to the 1997 Act as Section 104 (the predecessor of Section 203 of the 2018 Act) to complement the Uniform Prudent Investor Act that had been approved by the Uniform Law Commission in 1994. For a discussion of the prudent investor rule, including the investment considerations involving specific investments and techniques under the rule, *see* Restatement (Third) of Trusts § 90 (2007), comments *k* through *p* (originally published as Restatement (Third) of Trusts: Prudent Investor Rule § 227, comments *i* and *k* through *p* (1992)).

The purpose of the power to adjust between income and principal was to enable a fiduciary to select investments using the standards of a prudent investor without having to realize a particular portion of the portfolio's total return in the form of traditional trust accounting income such as interest, dividends, and rents. Section 104 authorized a fiduciary to make adjustments between income and principal if three conditions were met: (1) the fiduciary must be managing the trust assets under the prudent investor rule; (2) the terms of the trust must express the income beneficiary's distribution rights in terms of the right to receive "income" in the sense of traditional trust accounting income; and (3) the fiduciary must be unable to comply with the duty to administer the trust impartially, based on what is fair and reasonable to all the beneficiaries, without making an adjustment. In deciding whether and to what extent to exercise the power to adjust, the fiduciary was required to consider the factors described in what is now, with refinements, Section 201(e), but the fiduciary could not make an adjustment in circumstances described in what is now, with refinements, Section 203(e).

As stated in the Prefatory Note, new Section 203 is significantly expanded over former Section 104, especially by eliminating the three aforementioned preconditions. For the power to adjust to be available, trust distributions need not be constricted by the concept of "income" in a way that economic results from year to year could arbitrarily affect. In other words, while the trustee of a more modern trust with greater, if not total, flexibility to make distributions from income and/or principal would actually have been *denied* the flexibility intended by former Section 104, new Section 203 ensures that designing a trust for greater flexibility will not ironically sacrifice the flexibility of adjustments.

Section 203 does not empower a fiduciary to increase or decrease the degree of beneficial enjoyment to which a beneficiary is entitled under the terms of the trust; rather, it authorizes the fiduciary to make adjustments between income and principal that may be necessary or helpful if the income component of a portfolio's total return is too small or too large because of investment decisions made by the fiduciary under the prudent investor rule. The paramount considerations in applying Section 203(a), which replace the three preconditions of former Section 104, are the requirement in Section 201(a)(1) and (2) that "a fiduciary shall ...act in good faith, based on what is fair and reasonable to all beneficiaries [and] administer a trust or estate impartially, except to the extent the terms of the trust manifest an intent that the fiduciary shall or may favor one or more beneficiaries," and the precondition in Section 203(a) that "the fiduciary [determine] the exercise of the power to adjust will assist the fiduciary to administer the trust or estate impartially."

In other words, the power to adjust between income and principal under former Section 104(a) was available only when, without the power, the fiduciary would have been "unable" to administer the trust impartially because prudent investment for *total* return was not producing an

appropriate level of traditional trust *income* return to impartially balance the interests of the beneficiaries. Under new Section 203(a), that standard is relaxed when “the fiduciary determines the exercise of the power to adjust will *assist* the fiduciary to administer the trust or estate impartially.” The former standard of impossibility is replaced by a standard of assistance.

As further stated in the Prefatory Note, a trustee of a flexible trust that could have coped with the constraints of income and principal rules by merely accumulating income or invading principal now is given the alternative of making an adjustment under Section 203 instead. Under Section 203, a trustee of a discretionary trust can make adjustments, taking into account the nonexclusive list of factors provided in Section 201(e), and still achieve the comfortable outcome of “distributing income.” The 2018 Act contemplates that not only would some fiduciaries prefer the opportunity to continue to respect the formality of “distributing income to income beneficiaries,” but such a practice would also reassure beneficiaries and reduce some tendencies toward suspicion and conflict among beneficiaries. And when the interests of beneficiaries under the terms of the trust are still not appropriately served within the framework of “distributing income” – that is, when no reasonable adjustment would serve those interests, or when non-pro rata distributions are justified – then invasions of principal, if authorized by the terms of the trust, may still be necessary.

Factors to consider in exercising the power to adjust. The factors the fiduciary must consider in determining whether to exercise the power to adjust between income and principal, formerly found in Section 104(b) regarding the power to adjust, are now revised and set forth in Section 201(e), applicable to both the power to adjust between income and principal and the power to convert to or from a unitrust or change a unitrust. Section 203(d) refers to Section 201(e) in reference to the power to adjust. The differences between the factors in former Section 104(b) and those in new Section 201(e) are discussed in the Comment to Section 201.

Section 203(d) also requires that a fiduciary considering an exercise of the power to adjust consider the potential presence and effect of certain specific circumstances, namely the clarification of the character of a distribution from an entity under Section 401(i) after the fiduciary has made a distribution to trust beneficiaries on the basis of incorrect or incomplete information, the forgoing of specific small allocations between income and principal as insubstantial under Section 408, and the need under Section 413 to compensate a settlor’s spouse when the property in a marital trust is underproductive.

Duration of an exercise of the power to adjust. Section 104 of the 1997 Act did not state the trust accounting periods to which a fiduciary’s exercise of the power to adjust between income and principal would apply, suggesting that the power would be exercised year-by-year, although presumably a retrospective exercise in the first part of the following year would work. Section 203(j) of the 2018 Act explicitly provides that an exercise of the power in 2019, for example, may apply to 2018, 2019, and any subsequent years. Such an exercise, again as an example, would permit a fiduciary to take note that a particular long-term investment was likely to produce little or no accounting income but significant capital appreciation, and to provide accordingly for ongoing adjustments to occur as long as those conditions prevailed. While it still may be prudent to review such circumstances regularly, an announced commitment to a long-term strategy of adjustments might provide reassuring predictability and enhance the “regularity of income” cited as a factor for consideration in Section 201(e)(4).

Accountability to beneficiaries and review by the court. Section 203(k) clarifies that a description of a fiduciary's exercise of the power to adjust must be communicated to beneficiaries, either in the annual report contemplated by Section 813(c) of the Uniform Trust Code or by less formal communication at least annually.

The exercise or nonexercise of the power to adjust is subject to review by the court under an abuse-of-discretion standard pursuant to Section 202. Certain remedies available to the court are addressed in Section 202(c) and discussed in the Comment to Section 202.

Limitations on the power to adjust. Section 203(e) prohibits a trustee from exercising the power to adjust where the exercise or even possession of the power might produce unwelcome federal tax results. Many of the tax results new Section 203(e) seeks to avoid are carryovers from the former Section 104(c): loss of marital deduction (new Sections 203(e)(1) & 102(19)(C), former Section 104(c)(1)), loss of annual gift tax exclusion (203(e)(1) & 102(19)(A), 104(c)(2)), loss of annuity trust or unitrust treatment (203(e)(2), 104(c)(3)), charitable deduction (203(e)(3), 104(c)(4)), grantor trust treatment (203(e)(4), 104(c)(5)), and exposure to estate tax (203(e)(5), 104(c)(6)). Adverse results that the 2018 Act adds are disqualification of a trust to hold S corporation stock as a qualified subchapter S trust (QSST) under Section 102(19)(B), loss of grandfathered or exempt status for generation-skipping transfer tax (GST tax) purposes under Section 102(19)(D) and (E), and a taxable gift by a beneficiary or fiduciary (Section 203(e)(6)), as well as jeopardy of exemption for public benefit purposes (Section 203(e)(8)).

With respect to the "special tax benefits" defined in Section 102(19), however, the limitation of Section 203(e)(1) does not apply "to the extent the adjustment is made to provide for a reasonable apportionment of the total return of the trust between the current income beneficiary and successor beneficiaries." This is patterned after a safe harbor in Treasury Reg. §1.643(b)-1, discussed in the Comments to Sections 301 and 309.

In Section 104(c)(5) and (6) of the 1997 Act, the limitations to avoid grantor trust status and estate tax exposure were expressed as "if possessing or exercising the power to make an adjustment causes [the adverse result], and [the adverse result] would not [occur] if the trustee did not possess the power to make the adjustment." The second clause is omitted in Section 203(e)(5) and (6) because if the possessing or exercising the power "causes" the adverse result it necessarily follows that the adverse result would not occur but for the power.

In addition, the estate tax protection is extended to all individuals under Section 203(e)(5) of the 2018 Act, whereas it was limited to individuals with the power to remove or appoint a trustee under Section 104(c)(6) of the 1997 Act. But the limitation applies only to the exposure of "trust assets" to estate tax, not assets held outside the trust, including assets that have been distributed from the trust. Therefore, for example, the limitation is not implicated merely because the exercise of the power to adjust from principal to income might increase a distribution to an income beneficiary and thereby add to that beneficiary's estate held outside the trust.

Section 104(c)(7) and (8) of the 1997 Act prohibited exercise of the power to adjust "if the trustee is a beneficiary of the trust or ... the adjustment would benefit the trustee directly or indirectly." Section 203(e)(7) of the 2018 Act simply requires the fiduciary to be "an

independent person,” as defined in new Section 102(11). Like Section 104(d) of the 1997 Act, if some but not all co-fiduciaries are restricted from exercising the power, Section 203(f)(1) of the 2018 Act permits a qualified co-fiduciary to exercise the power, if permitted by the terms of the trust and applicable law. Section 203(f)(2) of the 2018 Act goes on to permit the appointment of a co-fiduciary for that purpose, even limited to that purpose.

Even in a case where Section 203(e) does not prohibit a trustee from adjusting between income and principal because certain tax advantages might be jeopardized, the trustee’s adjustment between income and principal does not necessarily determine or affect the amount of income that will be subject to federal income tax. Income for federal tax purposes is different from income for purposes of trust administration. As Treasury Reg. §1.643(b)-1 warns, “[t]rust provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized” for income tax purposes.

Section 203(e)(9) provides that the power to adjust is not available for a unitrust under Article 3.

Release or delegation of the power to adjust. Like Section 104(e) of the 1997 Act, Section 203(g) of the 2018 Act permits a fiduciary to release all or part of the power to adjust in circumstances in which the possession or exercise of the power might deprive the trust of a benefit or impose a burden or risk. In addition, Section 203 allows delegation of the power in such a case. Section 203(h) provides that a release or delegation may be limited to income, to principal, or in other ways, or may apply only for a limited time, which may be measured by a life or lives. If not limited, the default under Section 203(h) is that the release or delegation is complete and permanent.

Trust terms that limit a power to adjust. Like Section 104(f) of the 1997 Act, Section 203(i) of the 2018 Act acknowledges that the terms of a trust may limit the power to adjust, but only if the limitation expressly applies to “the power to adjust under subsection (a).”

[ARTICLE] 3

UNITRUST

SECTION 301. DEFINITIONS. In this [article]:

- (1) “Applicable value” means the amount of the net fair market value of a trust taken into account under Section 307.
- (2) “Express unitrust” means a trust for which, under the terms of the trust without regard to this [article], income or net income must or may be calculated as a unitrust amount.
- (3) “Income trust” means a trust that is not a unitrust.
- (4) “Net fair market value of a trust” means the fair market value of the assets of the trust,

less the noncontingent liabilities of the trust.

(5) “Unitrust” means a trust for which net income is a unitrust amount. The term includes an express unitrust.

(6) “Unitrust amount” means an amount computed by multiplying a determined value of a trust by a determined percentage. For a unitrust administered under a unitrust policy, the term means the applicable value, multiplied by the unitrust rate.

(7) “Unitrust policy” means a policy described in Sections 305 through 309 and adopted under Section 303.

(8) “Unitrust rate” means the rate used to compute the unitrust amount under paragraph (6) for a unitrust administered under a unitrust policy.

Comment

Background. The word “unitrust” can be traced at least to the literature of the mid-1960s. Lovell, “The Unitrust: A New Concept to Meet an Old Problem,” 105 *Trusts & Estates* 215 (1966); Del Cotto & Joyce, “Taxation of the Trust Annuity: The Unitrust Under the Constitution and the Internal Revenue Code,” 23 *Tax L. Rev.* 257 (1968). For many estate planners and charitable giving planners, the first introduction to the word may be in the term “charitable remainder unitrust” introduced by Congress in section 664, added to the Internal Revenue Code by the Tax Reform Act of 1969. The word was reprised following the enactment of section 2702 in Treasury Reg. § 25.2702-3(c), governing “qualified unitrust interests” in grantor retained unitrusts (“GRUTs”) (which are hardly ever used, if they are used at all).

While the precise origin or intent of the word is not totally clear, it appears derived from the notion that the trust consists of a *unified* fund—“a single fund [in which] there would be no distinction between income and principal,” only between “receipts” and “payouts.” Lovell, *supra*. The “unitrust” can be thought of as a trust in which there is a “unity” of interest between the current income beneficiary and the successor beneficiary, because both benefit from a higher value of the trust assets.

Thus, in current legal usage, a “unitrust” is simply a trust in which the periodic payout to the current income beneficiary is determined with reference to a percentage of the net value of the trust assets, determined from time to time, regardless of how much income is produced by the trust assets or the growth of the trust assets. As the value of the trust assets increases, the unitrust amount increases. As the value decreases, the unitrust amount decreases.

The “unity” of interest between the current income beneficiaries and the remainder or successor beneficiaries will enable the trustee to invest the assets for long-term growth to the

benefit of all beneficiaries. This will permit the mission of the trustee and investment team to be more focused. Investment decisions can be based on the needs and risk tolerances of the beneficiaries, and there is less likelihood of dissension between the current and future beneficiaries over investment policy. In addition, to the extent that a unitrust approach obviates discretionary invasions of principal, the trustee is protected against challenges by the remainder beneficiaries that any discretionary principal distributions were excessive. Similarly, a unitrust approach eliminates the need to make adjustments between income and principal under Section 203 and thus avoids or minimizes controversy over whether such adjustments are proper.

By the end of 2016, 36 states (Alabama, Alaska, Arizona, California, Colorado, Delaware, Florida, Georgia, Illinois, Indiana, Iowa, Kansas, Kentucky, Maine, Maryland, Missouri, Nebraska, Nevada, New Hampshire, New Mexico, New York, North Carolina, Oregon, Pennsylvania, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Utah, Vermont, Virginia, Washington, West Virginia, Wisconsin, and Wyoming) had enacted statutes, some as part of their Principal and Income Acts and some separately, permitting a trustee to convert a trust to a unitrust. Some of those statutes refer to unitrusts as "total return unitrusts" (a term not used in Article 3).

Response by the Internal Revenue Service. In February 2001, the Internal Revenue Service published proposed regulations it described in part as follows: "This document contains proposed regulations revising the definition of income under section 643(b) of the Internal Revenue Code to take into account changes in the definition of trust accounting income under state laws." The preamble to the proposed regulations noted:

These [then current] statutory and regulatory provisions [under section 643] date back to a time when, under state statutes, dividends and interest were considered income and were allocated to the income beneficiaries while capital gains were allocated to the principal of the trust. Changes in the types of available investments and in investment philosophies have caused states to revise, or to consider revising, these traditional concepts of income and principal....

To ensure that the income beneficiaries are not penalized if a trustee adopts a total return investment strategy, many states have made, or are considering making, revisions to the definitions of income and principal. Some state statutes permit the trustee to make an equitable adjustment between income and principal if necessary to ensure that both the income beneficiaries and the remainder beneficiaries are treated impartially, based on what is fair and reasonable to all the beneficiaries. Thus, a receipt of capital gains that previously would have been allocated to principal may be allocated by the trustee to income if necessary to treat both parties impartially. Conversely, a receipt of dividends or interest that previously would have been allocated to income may be allocated by the trustee to principal if necessary to treat both parties impartially.

Other states are proposing legislation that would allow the trustee to pay a unitrust amount to an income beneficiary in satisfaction of that beneficiary's right to the income from the trust. This unitrust amount will be a fixed percentage, sometimes required to be within a range set by state statute, of the fair market value of the trust assets determined annually.

Questions have arisen concerning how these state statutory changes affect the definition of income provided in section 643(b) and the other Code provisions that rely on the section 643(b) definition of income. This definition of income affects trusts including, but not limited to, ordinary trusts, charitable remainder trusts, pooled income funds, and qualified subchapter S trusts.

In short, revision of the regulations was proposed to respond to changes in circumstances, including changes in the pressures on a trustee faced with an obligation to invest for total return under the prudent investor rule and faced with the remedies of principal-income adjustments under the 1997 Revised Uniform Principal and Income Act and of conversion to a total return unitrust.

The final regulations were released on December 30, 2003. Treasury Reg. §1.643(b)-1 states, in part:

[A]n allocation of amounts between income and principal pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, including ordinary and tax-exempt income, capital gains, and appreciation. For example, a state statute providing that income is a unitrust amount of no less than 3% and no more than 5% of the fair market value of the trust assets, whether determined annually or averaged on a multiple year basis, is a reasonable apportionment of the total return of the trust.

Article 3. The typical state unitrust statute limits unitrust conversions to the parameters in the Treasury Regulations – “a unitrust amount of no less than 3% and no more than 5% of the fair market value of the trust assets, whether determined annually or averaged on a multiple year basis.” Article 3 borrows heavily from that existing state legislation, but it is broader and more flexible than the laws of most states. The 2018 Act does not limit state law by these specialized federal regulations and includes in Article 3 many more features and refinements than only a 3-to-5-percent range and the potential for annual averaging, to permit a unitrust to even better serve the objective of achieving more stability and predictability for beneficiaries.

One such refinement is to provide that the trust distribute a percentage of its market value determined on the basis of a rolling average of values for periods other than years. Twelve quarters is an example. This can reduce potential fluctuations in distributions caused by short-swing movements in the stock market. Although the rate of increase in the unitrust distribution to the current income beneficiary will lag the performance of the portfolio, the current income beneficiary will benefit in down years. Another similar refinement designed to reduce risk to all the beneficiaries is to place a ceiling and/or a floor on the unitrust payout amount, or on the size of fluctuation of the unitrust amount from year to year or period to period. More fundamental refinements include a variable unitrust rate itself, perhaps drawn from specified market data, and different treatment for different types of assets, including the total exclusion of certain assets and the income therefrom. Sections 305-309(a) allow all variations of that kind. To afford a trustee the benefit of the safe harbor in the Treasury regulations in situations where it applies, Section 309(b) limits the parameters in those situations to the parameters specified in that safe harbor. The situations where Section 309(b) applies, described as situations in which the trust offers a “special tax benefit,” which is defined in Section 102(19), are built around situations addressed

in the 2003 Treasury Regulations.

Because of the broad flexibility Article 3 allows, it is not necessary to provide specific statutory fixes for specific identified challenges, including computational challenges like the treatment of accrued but unpaid income and the treatment of property that is personally used and not invested.

In addition to the requirements in Sections 303(b)(2) and 304 for sending notice of a proposed conversion to or from a unitrust or change to a unitrust, some state statutes also require the trustee to send a copy of the state unitrust statute. If the other, somewhat more detailed, requirements of this Article 3 are followed, that seems unnecessary, although any state that chooses may still add it.

Like some state unitrust statutes, Article 3 applies to “express unitrusts,” defined in Section 301(2) to be “a trust for which, under the terms of the trust without regard to this [article], income or net income must or may be calculated as a unitrust amount.” This scope of Article 3 is confirmed in Section 301(5), which includes an express unitrust in the general definition of a “unitrust,” in Section 301(6), in which the definition of a “unitrust amount” “includes” the unitrust amount determined under Article 3 but also covers any “amount computed by multiplying a determined value of a trust by a determined percentage” (as in an express unitrust), and in Section 302(a)(2), which includes an express unitrust in the application of Article 3. This definition and scope are carried out in Section 303(a)(2) and (3), which provides that any unitrust (which includes an express unitrust under Section 301(5)) may be changed (Section 303(a)(2)) or converted (not just “converted *back*”) to an income trust (Section 303(a)(3)). Thus the Comments to this act refer to “the power to convert to or from a unitrust or change a unitrust,” although the act itself (in Sections 201(d) and 202(a)(2) and (c)(2)) is more formal.

As in the case of the power to adjust between income and principal provided in Section 203 and discussed in the Comment to Section 203, Section 302(c) provides that a trust may be converted to a unitrust regardless of the terms of the trust governing distributions – that is, even though distributions are not defined or limited by the amount of net income of the trust. This is a departure from current state laws, but it reflects the overall commitment to flexibility in the 2018 Act that is discussed in the Comment to Section 302. Like the power to adjust, Section 303(b)(1) makes the power to convert to or from a unitrust or change a unitrust available when “the fiduciary determines that the action will *assist* the fiduciary to administer a trust impartially.”

SECTION 302. APPLICATION; DUTIES AND REMEDIES.

(a) Except as otherwise provided in subsection (b), this [article] applies to:

(1) an income trust, unless the terms of the trust expressly prohibit use of this [article] by a specific reference to this [article] or an explicit expression of intent that net income not be calculated as a unitrust amount; and

(2) an express unitrust, except to the extent the terms of the trust explicitly:

(A) prohibit use of this [article] by a specific reference to this [article];

(B) prohibit conversion to an income trust; or

(C) limit changes to the method of calculating the unitrust amount.

(b) This [article] does not apply to a trust described in Section 170(f)(2)(B), 642(c)(5), 664(d), 2702(a)(3)(A)(ii) or (iii), or 2702(b) of the Internal Revenue Code of 1986~~, as amended,~~ 26 U.S.C. Section 170(f)(2)(B), 642(c)(5), 664(d), 2702(a)(3)(A)(ii) or (iii), or 2702(b)~~, as amended~~.

(c) An income trust to which this [article] applies under subsection (a)(1) may be converted to a unitrust under this [article] regardless of the terms of the trust concerning distributions. Conversion to a unitrust under this [article] does not affect other terms of the trust concerning distributions of income or principal.

(d) This [article] applies to an estate only to the extent a trust is a beneficiary of the estate. To the extent of the trust's interest in the estate, the estate may be administered as a unitrust, the administration of the estate as a unitrust may be discontinued, or the percentage or method used to calculate the unitrust amount may be changed, in the same manner as for a trust under this [article].

(e) This [article] does not create a duty to take or consider action under this [article] or to inform a beneficiary about the applicability of this [article].

(f) A fiduciary that in good faith takes or fails to take an action under this [article] is not liable to a person affected by the action or inaction.

Legislative Note: A United States Code citation (U.S.C.) follows a reference to the federal Internal Revenue Code in subsection (b). The United States Code citation is included as an aid to the reader. If the state's convention is to omit the United States Code citation, simply delete the United States Code citation. In states in which the constitution, or other law, does not permit the

phrase “as amended” when federal statutes are incorporated into state law, the phrase should be omitted.

Comment

Section 302(a)(2) includes “express unitrusts” within the scope of Article 3. Section 302(b) excludes charitable lead annuity trusts and unitrusts (CLATs and CLUTs), pooled income funds (PIFs), charitable remainder annuity trusts and unitrusts (CRATs and CRUTs), personal residence trusts and qualified personal residence trusts (PRTs and QPRTs), and grantor retained annuity trusts and unitrusts (GRATs and GRUTs).

Section 302(c) confirms that conversion of an income trust to a unitrust does not depend on the terms of the trust concerning distributions. In other words, a unitrust conversion is available even for a trust in which a trustee may accumulate income or invade principal. This works both ways under Section 302(c). Discretion over distributions does not disqualify an income trust from converting to a unitrust, and neither does conversion to a unitrust change the trustee’s discretion to accumulate income (even the unitrust amount, although that may be unusual) or invade principal above the unitrust amount. This carries out the objective of the 2018 Act, explained in the Prefatory Note and in the Comment to Section 203, to allow a fiduciary to respect the simple, predictable, and reassuring notion of “income” (in this case a unitrust amount) without necessarily relying on accumulations of income or invasions of principal as a first resort.

Section 302(d) provides that Article 3 applies to a decedent’s estate only to the extent a trust is a beneficiary of the estate. To that extent, the estate, or part of the estate, is treated for all purposes the same as a trust under Article 3. Thus, there are no other references to estates in Article 3.

Section 302(e) rejects any creation of an affirmative duty to act under Article 3 or to inform beneficiaries of the actions available under Article 3. And Section 302(f) exonerates a fiduciary that in good faith acts or fails to act under Article 3.

SECTION 303. AUTHORITY OF FIDUCIARY.

(a) A fiduciary, without court approval, by complying with subsections (b) and (f), may:

(1) convert an income trust to a unitrust if the fiduciary adopts in a record a unitrust policy for the trust providing:

(A) that in administering the trust the net income of the trust will be a unitrust amount rather than net income determined without regard to this [article]; and

(B) the percentage and method used to calculate the unitrust amount;

(2) change the percentage or method used to calculate a unitrust amount for a

unitrust if the fiduciary adopts in a record a unitrust policy or an amendment or replacement of a unitrust policy providing changes in the percentage or method used to calculate the unitrust amount; or

(3) convert a unitrust to an income trust if the fiduciary adopts in a record a determination that, in administering the trust, the net income of the trust will be net income determined without regard to this [article] rather than a unitrust amount.

(b) A fiduciary may take an action under subsection (a) if:

(1) the fiduciary determines that the action will assist the fiduciary to administer a trust impartially;

(2) the fiduciary sends a notice in a record, in the manner required by Section 304, describing and proposing to take the action;

(3) the fiduciary sends a copy of the notice under paragraph (2) to each settlor of the trust which is:

(A) if an individual, living; or

(B) if not an individual, in existence;

(4) at least one member of each class{ of the qualified beneficiaries determined under K.S.A. 58a-103(12), and amendments thereto, [Uniform Trust Code Section 103(13)], other than {the Attorney General},} receiving the notice under paragraph (2) is:

(A) if an individual, legally competent; [or]

(B) if not an individual, in existence; [or]

(C) represented in the manner provided in Section 304(b);] and

(5) the fiduciary does not receive, by the date specified in the notice under Section 304{(d)(5)}{(e)(5)}, an objection in a record to the action proposed under paragraph (2) from a

person to which the notice under paragraph (2) is sent.

(c) If a fiduciary receives, not later than the date stated in the notice under Section 304[(d)(5)][(e)(5)], an objection in a record described in Section 304[(d)(4)][(e)(4)] to a proposed action, the fiduciary or a beneficiary may request the court to have the proposed action taken as proposed, taken with modifications, or prevented. A person described in Section 304(a) may oppose the proposed action in the proceeding under this subsection, whether or not the person:

(1) consented under Section 304[(c)][(b)]; or

(2) objected under Section 304[(d)(4)][(e)(4)].

(d) If, after sending a notice under subsection (b)(2), a fiduciary decides not to take the action proposed in the notice, the fiduciary shall notify in a record each person described in Section 304(a) of the decision not to take the action and the reasons for the decision.

(e) If a beneficiary requests in a record that a fiduciary take an action described in subsection (a) and the fiduciary declines to act or does not act within 90 days after receiving the request, the beneficiary may request the court to direct the fiduciary to take the action requested.

(f) In deciding whether and how to take an action authorized by subsection (a), or whether and how to respond to a request by a beneficiary under subsection (e), a fiduciary shall consider all factors relevant to the trust and the beneficiaries, including relevant factors in Section 201(e).

(g) A fiduciary may release or delegate the power to convert an income trust to a unitrust under subsection (a)(1), change the percentage or method used to calculate a unitrust amount under subsection (a)(2), or convert a unitrust to an income trust under subsection (a)(3), for a reason described in Section 203(g) and in the manner described in Section 203(h).

Legislative Note: In subsection (b)(4), refer to Uniform Trust Code Section 103(13), or modify subsection (b)(4) appropriately or refer to the corresponding provision of the state's trust law if the state has not enacted the Uniform Trust Code.

In subsections (b)(5) and (c), use the reference in the first set of brackets if Alternative A of Section 304 is used and use the reference in the second set of brackets if Alternative B of Section 304 is used.

Comment

Section 303 sets forth, in effect, the road map for action under Article 3: the options under Section 303(a), a determination that impartiality will be assisted under Section 303(b)(1), notice to beneficiaries under Section 303(b)(2) with a copy to the settlor or settlors under Section 303(b)(3), existence of a competent potential party under Section 303(b)(4), a wait for a prescribed time before acting under Section 303(b)(5), and an opportunity to ask for court approval under Section 303(c) if there is a timely objection. There is also an opportunity under Section 303(e) for a beneficiary to seek the help of the court if the beneficiary asks the fiduciary to act under Article 3 and the fiduciary refuses or fails to act.

Although the recipients of the required notice are set forth in detail in Section 304, settlors are included only here in Section 303(b)(3) and are said to receive only "a copy of the notice." This is done to avoid unintentionally making the settlor of an irrevocable trust over which he or she has relinquished all power a party to a proceeding with a voice in the matter that could be construed as retained control of the trust. See Section 303(c), which provides that "[a] person described in Section 304(a) may oppose the proposed action in the proceeding under this subsection," and Section 304[(d)][(c)](4), which requires the notice to state that everyone who receives the notice "may object to the proposed action." This is a departure from the Uniform Trust Decanting Act (UTDA), for example, which includes the requirement for notice to the settlor in the same list, indeed at the head of the list (Section 7(c)(1)), of all persons entitled to notice. But there may be reasons unique to decanting to give formal notice to the settlor. Section 19(b)(10) of UTDA, for example, allows a settlor to block a fiduciary's decanting proposal if the decanting would reduce the settlor's power to avoid or terminate grantor trust status, which typically would not be implicated by a unitrust conversion.

Section 303(a)(1)(A) states that in a unitrust "the net income of the trust will be a unitrust amount rather than net income determined without regard to this [article]." Thus, for example, because "net income" already reflects the disbursements made from income, there will be no deductions from the unitrust amount for expenses unless the unitrust policy expressly allows it.

Like the power to adjust, the power to convert to or from a unitrust or change a unitrust is governed by consideration of the same factors under Sections 303(f) and 201(e), and a fiduciary may release or delegate the power under Section 303(g).

SECTION 304. NOTICE.

Alternative A

(a) A notice required by Section 303(b)(2) must be sent in a manner authorized under K.S.A. 58a-109, and amendments thereto,~~[Uniform Trust Code Section 109]~~ to:

(1) the qualified beneficiaries determined under K.S.A. 58a-103(12), and amendments thereto ~~[Uniform Trust Code Section 103(13)]~~, other than ~~[the Attorney General]~~; ~~[and]~~

(2) ~~[each person acting as trust director of the trust under the Uniform Directed Trust Act]~~~~[each person that is granted a power over the trust by the terms of the trust, to the extent the power is exercisable when the person is not then serving as a trustee:~~

(A) including a:

(i) power over the investment, management, or distribution of trust property or other matters of trust administration; and

(ii) power to appoint or remove a trustee or person described in this paragraph; and

(B) excluding a:

(i) power of appointment;

(ii) power of a beneficiary over the trust, to the extent the exercise or nonexercise of the power affects the beneficial interest of the beneficiary or another beneficiary represented by the beneficiary under K.S.A. 58a-301 through K.S.A. 58a-305, and amendments thereto, ~~[Uniform Trust Code Sections 301 through 305]~~ with respect to the exercise or nonexercise of the power; and

(iii) power over the trust if the terms of the trust provide that the

power is held in a nonfiduciary capacity and the power must be held in a nonfiduciary capacity to achieve a tax objective under the Internal Revenue Code of 1986~~[, as amended,]~~, 26 U.S.C.~~[, as amended]]~~; and

~~_____ (3) each person that is granted a power by the terms of the trust to appoint or remove a trustee or person described in paragraph (2), to the extent the power is exercisable when the person that exercises the power is not then serving as a trustee or person described in paragraph (2)].~~

(b) The representation provisions of K.S.A. 58a-301 through 58a-305, and amendments thereto, ~~[Uniform Trust Code Sections 301 through 305]~~ apply to notice under this section.

Alternative B

~~_____ (a) A notice required by Section 303(b)(2) must be sent to:~~

~~_____ (1) all beneficiaries that receive or are entitled to receive income from the trust or would be entitled to receive a distribution of principal if the trust were terminated at the time the notice is sent, assuming no power of appointment is exercised; [and]~~

~~_____ (2) [each person acting as trust director of the trust under the Uniform Directed Trust Act][each person that is granted a power over the trust by the terms of the trust, to the extent the power is exercisable when the person is not then serving as a trustee:~~

~~_____ (A) including a:~~

~~_____ (i) power over the investment, management, or distribution of trust property or other matters of trust administration; and~~

~~_____ (ii) power to appoint or remove a trustee or person described in this paragraph; and~~

~~_____ (B) excluding a:~~

- ~~_____ (i) power of appointment;~~
- ~~_____ (ii) power of a beneficiary over the trust, to the extent the exercise or nonexercise of the power affects the beneficial interest of the beneficiary; and~~
- ~~_____ (iii) power over the trust if the terms of the trust provide that the power is held in a nonfiduciary capacity and the power must be held in a nonfiduciary capacity to achieve a tax objective under the Internal Revenue Code of 1986[, as amended,] 26 U.S.C.[, as amended]]]; and~~
- ~~_____ (3) each person that is granted a power by the terms of the trust to appoint or remove a trustee or person described in paragraph (2), to the extent the power is exercisable when the person that exercises the power is not then serving as a trustee or person described in paragraph (2)].~~

End of Alternatives

~~{(c)}{(b)}~~ A person may consent in a record at any time to action proposed under Section 303(b)(2). A notice required by Section 303(b)(2) need not be sent to a person that consents under this subsection.

~~{(d)}{(e)}~~ A notice required by Section 303(b)(2) must include:

- (1) the action proposed under Section 303(b)(2);
- (2) for a conversion of an income trust to a unitrust, a copy of the unitrust policy adopted under Section 303(a)(1);
- (3) for a change in the percentage or method used to calculate the unitrust amount, a copy of the unitrust policy or amendment or replacement of the unitrust policy adopted under Section 303(a)(2);
- (4) a statement that the person to which the notice is sent may object to the

proposed action by stating in a record the basis for the objection and sending or delivering the record to the fiduciary;

(5) the date by which an objection under paragraph (4) must be received by the fiduciary, which must be at least 30 days after the date the notice is sent;

(6) the date on which the action is proposed to be taken and the date on which the action is proposed to take effect;

(7) the name and contact information of the fiduciary; and

(8) the name and contact information of a person that may be contacted for additional information.

Legislative Note: Use Alternative A and the designations in the first set of brackets if the state has enacted the Uniform Trust Code. Use Alternative B and the subsection designations in the second set of brackets if the state has not enacted the Uniform Trust Code.

A United States Code citation (U.S.C.) follows a reference to the federal Internal Revenue Code in subsection (a)(2)(B)(iii). The United States Code citation is included as an aid to the reader. If the state's convention is to omit the United States Code citation, simply delete the United States Code citation. In states in which the constitution, or other law, does not permit the phrase "as amended" when federal statutes are incorporated into state law, the phrase should be omitted.

In Alternative A or B, modify subsection (a)(2) to refer to the Uniform Directed Trust Act and include subsection (a)(3) if the state has enacted the Uniform Directed Trust Act, or modify subsection (a)(2) appropriately and omit subsection (a)(3) if the state has not enacted the Uniform Directed Trust Act.

Comment

Section 304 provides details of the fiduciary's notice to beneficiaries. Subsection (a) is offered in two Alternatives, Alternative A for a state that has enacted the Uniform Trust Code and Alternative B for a state that hasn't. Alternative A also includes a subsection (b) that affirms the application of the UTC representation rules. Generally, a detailed notice goes to "qualified beneficiaries" in the UTC sense, as both current and successor beneficiaries are affected by the administration of a trust as a unitrust. Subsection (d) (in the UTC case) or (c) (in the non-UTC case) requires, in paragraphs (7) and (8), the name and contact information of the fiduciary and of a person that may be contacted for additional information. "Contact information" is left open-ended, to accommodate any reasonably accessible technology or medium.

SECTION 305. UNITRUST POLICY.

(a) In administering a unitrust under this [article], a fiduciary shall follow a unitrust policy adopted under Section 303(a)(1) or (2) or amended or replaced under Section 303(a)(2).

(b) A unitrust policy must provide:

(1) the unitrust rate or the method for determining the unitrust rate under Section 306;

(2) the method for determining the applicable value under Section 307; and

(3) the rules described in Sections 306 through 309 which apply in the administration of the unitrust, whether the rules are:

(A) mandatory, as provided in Sections 307(a) and 308(a); or

(B) optional, as provided in Sections 306, 307(b), 308(b), and 309(a), to

the extent the fiduciary elects to adopt those rules.

Comment

Section 305 provides for a “unitrust policy,” which will include a few mandatory details spelled out in Sections 306 through 308 and may include many more optional details mentioned in those sections. It is in those sections where broad flexibility is encountered, including a unitrust rate under Section 306 that may be less than 3 percent or more than 5 percent and a period under Section 308 that may be something other than a calendar year. For exceptions to that flexibility in certain cases, see Section 309 and the Comment thereto.

SECTION 306. UNITRUST RATE.

(a) Except as otherwise provided in Section 309(b)(1), a unitrust rate may be:

(1) a fixed unitrust rate; or

(2) a unitrust rate that is determined for each period using:

(A) a market index or other published data; or

(B) a mathematical blend of market indices or other published data over a

stated number of preceding periods.

(b) Except as otherwise provided in Section 309(b)(1), a unitrust policy may provide:

(1) a limit on how high the unitrust rate determined under subsection (a)(2) may rise;

(2) a limit on how low the unitrust rate determined under subsection (a)(2) may fall;

(3) a limit on how much the unitrust rate determined under subsection (a)(2) may increase over the unitrust rate for the preceding period or a mathematical blend of unitrust rates over a stated number of preceding periods;

(4) a limit on how much the unitrust rate determined under subsection (a)(2) may decrease below the unitrust rate for the preceding period or a mathematical blend of unitrust rates over a stated number of preceding periods; or

(5) a mathematical blend of any of the unitrust rates determined under subsection (a)(2) and paragraphs (1) through (4).

SECTION 307. APPLICABLE VALUE.

(a) A unitrust policy must provide the method for determining the fair market value of an asset for the purpose of determining the unitrust amount, including:

(1) the frequency of valuing the asset, which need not require a valuation in every period; and

(2) the date for valuing the asset in each period in which the asset is valued.

(b) Except as otherwise provided in Section 309(b)(2), a unitrust policy may provide methods for determining the amount of the net fair market value of the trust to take into account in determining the applicable value, including:

(1) obtaining an appraisal of an asset for which fair market value is not readily

available;

(2) exclusion of specific assets or groups or types of assets;

(3) other exceptions or modifications of the treatment of specific assets or groups

or types of assets;

(4) identification and treatment of cash or property held for distribution;

(5) use of:

(A) an average of fair market values over a stated number of preceding

periods; or

(B) another mathematical blend of fair market values over a stated number

of preceding periods;

(6) a limit on how much the applicable value of all assets, groups of assets, or

individual assets may increase over:

(A) the corresponding applicable value for the preceding period; or

(B) a mathematical blend of applicable values over a stated number of

preceding periods;

(7) a limit on how much the applicable value of all assets, groups of assets, or

individual assets may decrease below:

(A) the corresponding applicable value for the preceding period; or

(B) a mathematical blend of applicable values over a stated number of

preceding periods;

(8) the treatment of accrued income and other features of an asset which affect

value; and

(9) determining the liabilities of the trust, including treatment of liabilities to

conform with the treatment of assets under paragraphs (1) through (8).

Comment

In determining the amount to which the unitrust rate is applied to determine the unitrust amount, a fiduciary first determines the fair market value of *each* asset that is not excluded under Section 307(b)(2). Fair market value is just that, fair market value in the usual sense. Next, the fiduciary adds the fair market values of *all* those assets together and subtracts the noncontingent liabilities of the trust to determine “net fair market value of the trust,” as defined in Section 301(4). Finally, the fiduciary applies the actions described in Section 307(b)(3) through (9), to the extent provided by the unitrust policy (as well as other actions provided by the unitrust policy under Section 309(a)(3)), to determine the “applicable value.” It is the applicable value that is multiplied by the unitrust rate to determine the unitrust amount, which is deemed to be the net income of the trust under Section 303(a)(1)(A) or (2). Thus, unlike fair market value, the “applicable value” may be affected by the actions taken under Section 307(b)(3) through (9). Those actions may be somewhat artificial, in that they are not produced by the market as is “fair market value.” In fact, most of those actions are intended to counterbalance the effects of the market to provide a smoother and more predictable unitrust amount from year to year.

Like the “terms of *a* trust” and “terms of *the* trust” discussed in the Comment to Section 102, “net fair market value of *a* trust” (in Section 301(1) and (4)) and “net fair market value of *the* trust” in Section 307(b) are used interchangeably, depending on whether there has been a reference to a trust, either explicitly or indirectly, previously in the subsection or paragraph. In Section 307(b), that previous reference to a trust is imbedded in the term “unitrust policy.”

SECTION 308. PERIOD.

(a) A unitrust policy must provide the period used under Sections 306 and 307. Except as otherwise provided in Section 309(b)(3), the period may be:

- (1) a calendar year;
- (2) a 12-month period other than a calendar year;
- (3) a calendar quarter;
- (4) a three-month period other than a calendar quarter; or
- (5) another period.

(b) Except as otherwise provided in Section 309(b), a unitrust policy may provide standards for:

- (1) using fewer preceding periods under Section 306(a)(2)(B) or (b)(3) or (4) if:

(A) the trust was not in existence in a preceding period; or
(B) market indices or other published data are not available for a preceding period;

(2) using fewer preceding periods under Section 307(b)(5)(A) or (B), (6)(B), or (7)(B) if:

(A) the trust was not in existence in a preceding period; or
(B) fair market values are not available for a preceding period; and

(3) prorating the unitrust amount on a daily basis for a part of a period in which the trust or the administration of the trust as a unitrust or the interest of any beneficiary commences or terminates.

SECTION 309. SPECIAL TAX BENEFITS; OTHER RULES.

(a) A unitrust policy may:

(1) provide methods and standards for:

(A) determining the timing of distributions;

(B) making distributions in cash or in kind or partly in cash and partly in

kind; or

(C) correcting an underpayment or overpayment to a beneficiary based on the unitrust amount if there is an error in calculating the unitrust amount;

(2) specify sources and the order of sources, including categories of income for federal income tax purposes, from which distributions of a unitrust amount are paid; or

(3) provide other standards and rules the fiduciary determines serve the interests of the beneficiaries.

(b) If a trust qualifies for a special tax benefit or a fiduciary is not an independent person:

- (1) the unitrust rate established under Section 306 may not be less than three percent or more than five percent;
- (2) the only provisions of Section 307 which apply are Section 307(a) and (b)(1), (4), (5)(A), and (9);
- (3) the only period that may be used under Section 308 is a calendar year under Section 308(a)(1); and
- (4) the only other provisions of Section 308 which apply are Section 308(b)(2)(A) and (3).

Comment

Section 309(a) provides that a unitrust policy may include details beyond even the broad scope of Sections 306 through 308. One specific example, in paragraph (2), is to “specify sources and the order of sources, including categories of income for federal income tax purposes, from which distributions of a unitrust amount are paid.” Approximately two-thirds of the state unitrust statutes include a default “ordering rule,” although five of those default rules are limited to net accounting income or ordinary income and leave the ordering of short- and long-term capital gains, for example, to the fiduciary’s discretion. Although the 2018 Act does not include such an ordering rule, Section 309(a)(2) makes it clear that the fiduciary may include an ordering rule in a proposed unitrust policy.

Importantly, Section 309(b) addresses trusts that qualify for a “special tax benefit” defined in Section 102(19) – the annual gift tax exclusion, eligibility of a qualified subchapter S trust (QSST), an estate or gift tax marital deduction, or exemption from generation-skipping transfer tax (GST tax) – and trusts with a fiduciary that is not an “independent person” defined in Section 102(11). For those trusts, much of the expanded flexibility of Article 3 is denied, and, specifically, the unitrust rate is limited to 3-5 percent and the period used for calculation is limited to a calendar year. This protects the trust under the following safe harbor in Treasury Reg. §1.643(b)-1 (Dec. 30, 2003) (emphasis added):

[A]n allocation of amounts between income and principal pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, including ordinary and tax-exempt income, capital gains, and appreciation. For example, a state statute providing that income is a unitrust amount of *no less than 3% and no more than 5%* of the fair market value of the trust assets, whether determined *annually or averaged on a multiple year basis*, is a reasonable apportionment of the total return of the trust.

Although two of the “special tax benefits” – the gift tax exclusion and the marital deduction – are short-term, and there are often alternatives to QSSTs and non-independent

trustees, GST tax exemption is anything but short-term, is unavoidable, and is often crucial in the type of large long-term or even perpetual trust that is perhaps the most typical candidate for a unitrust conversion. And although “no less than 3% and no more than 5% of the fair market value of the trust assets, whether determined annually or averaged on a multiple year basis” is explicitly offered in the Treasury regulation only as an “example,” it is expressly incorporated into the regulations for GST-grandfathered trusts (Treasury Reg. §26.2601-1(b)(4)(i)(D)(2) & (E), *Example 11*), and the GST tax stakes are typically so high that few fiduciaries or beneficiaries would want to assume the risk. The focus of the regulation is on what the “state statute provid[es].” Therefore, Section 309(b) respects this safe harbor for such trusts.

[ARTICLE] 4

ALLOCATION OF RECEIPTS

[PART] 1

RECEIPTS FROM ENTITY

SECTION 401. CHARACTER OF RECEIPTS FROM ENTITY.

(a) In this section:

(1) “Capital distribution” means an entity distribution of money which is a:

(A) return of capital; or

(B) distribution in total or partial liquidation of the entity.

(2) “Entity”:

(A) means a corporation, partnership, limited liability company, regulated investment company, real estate investment trust, common trust fund, or any other organization or arrangement in which a fiduciary owns or holds an interest, whether or not the entity is a taxpayer for federal income tax purposes; and

(B) does not include:

(i) a trust or estate to which Section 402 applies;

(ii) a business or other activity to which Section 403 applies which is not conducted by an entity described in subparagraph (A);

(iii) an asset-backed security; or

(iv) an instrument or arrangement to which Section 416 applies.

(3) "Entity distribution" means a payment or transfer by an entity made to a person in the person's capacity as an owner or holder of an interest in the entity.

(b) In this section, an attribute or action of an entity includes an attribute or action of any other entity in which the entity owns or holds an interest, including an interest owned or held indirectly through another entity.

(c) Except as otherwise provided in subsection (d)(2) through (4), a fiduciary shall allocate to income:

(1) money received in an entity distribution; and

(2) tangible personal property of nominal value received from the entity.

(d) A fiduciary shall allocate to principal:

(1) property received in an entity distribution which is not:

(A) money; or

(B) tangible personal property of nominal value;

(2) money received in an entity distribution in an exchange for part or all of the fiduciary's interest in the entity, to the extent the entity distribution reduces the fiduciary's interest in the entity relative to the interests of other persons that own or hold interests in the entity;

(3) money received in an entity distribution that the fiduciary determines or estimates is a capital distribution; and

(4) money received in an entity distribution from an entity that is:

(A) a regulated investment company or real estate investment trust if the money received is a capital gain dividend for federal income tax purposes; or

(B) treated for federal income tax purposes comparably to the treatment described in subparagraph (A).

(e) A fiduciary may determine or estimate that money received in an entity distribution is a capital distribution:

(1) by relying without inquiry or investigation on a characterization of the entity distribution provided by or on behalf of the entity, unless the fiduciary:

(A) determines, on the basis of information known to the fiduciary, that the characterization is or may be incorrect; or

(B) owns or holds more than 50 percent of the voting interest in the entity;

(2) by determining or estimating, on the basis of information known to the fiduciary or provided to the fiduciary by or on behalf of the entity, that the total amount of money and property received by the fiduciary in the entity distribution or a series of related entity distributions is or will be greater than 20 percent of the fair market value of the fiduciary's interest in the entity; or

(3) if neither paragraph (1) nor (2) applies, by considering the factors in subsection (f) and the information known to the fiduciary or provided to the fiduciary by or on behalf of the entity.

(f) In making a determination or estimate under subsection (e)(3), a fiduciary may consider:

(1) a characterization of an entity distribution provided by or on behalf of the entity;

(2) the amount of money or property received in:

(A) the entity distribution; or

(B) what the fiduciary determines is or will be a series of related entity distributions;

(3) the amount described in paragraph (2) compared to the amount the fiduciary determines or estimates is, during the current or preceding accounting periods:

(A) the entity's operating income;

(B) the proceeds of the entity's sale or other disposition of:

(i) all or part of the business or other activity conducted by the entity;

(ii) one or more business assets that are not sold to customers in the ordinary course of the business or other activity conducted by the entity; or

(iii) one or more assets other than business assets, unless the entity's primary activity is to invest in assets to realize gain on the disposition of all or some of the assets;

(C) if the entity's primary activity is to invest in assets to realize gain on the disposition of all or some of the assets, the gain realized on the disposition;

(D) the entity's regular, periodic entity distributions;

(E) the amount of money the entity has accumulated;

(F) the amount of money the entity has borrowed;

(G) the amount of money the entity has received from the sources described in Sections 407, 410, 411, and 412; and

(H) the amount of money the entity has received from a source not otherwise described in this paragraph; and

(4) any other factor the fiduciary determines is relevant.

(g) If, after applying subsections (c) through (f), a fiduciary determines that a part of an entity distribution is a capital distribution but is in doubt about the amount of the entity distribution which is a capital distribution, the fiduciary shall allocate to principal the amount of the entity distribution which is in doubt.

(h) If a fiduciary receives additional information about the application of this section to an entity distribution before the fiduciary has paid part of the entity distribution to a beneficiary, the fiduciary may consider the additional information before making the payment to the beneficiary and may change a decision to make the payment to the beneficiary.

(i) If a fiduciary receives additional information about the application of this section to an entity distribution after the fiduciary has paid part of the entity distribution to a beneficiary, the fiduciary is not required to change or recover the payment to the beneficiary but may consider that information in determining whether to exercise the power to adjust under Section 203.

Comment

Entities to which Section 401 applies. Section 401 covers distributions from all types of entities. For example, the reference to partnerships in Section 401(a)(2)(A) includes all forms of partnerships, including limited partnerships, limited liability partnerships, and variants that have slightly different names and characteristics from state to state. And subsection (b) provides that the same is true of a chain or chains of entities, whether the entities are the same or different and no matter how many tiers the entities represent. This section does not apply, however, to receipts from an interest in property that a fiduciary 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 interest is regarded as that of a tenant-in-common.

Section 401(a)(2)(A) of the 2018 Act clarifies that Section 401 applies to an entity that meets these tests whether or not the entity is respected for federal income tax purposes. In Section 401(a)(2)(B) the 2018 Act retains the exceptions from the application of Section 401 in Section 401(a) of the 1997 Act, except that it clarifies that it does not exclude a business that might appear to be described in Section 403 if it is conducted in an entity that is subject to Section 401 under Section 401(a)(2)(A). This clarification and a similar clarification to Section 403(a)(2) prevent what might otherwise seem to be a circularity between Sections 401 and 403, with each of those sections excluding an entity described in the other section.

Terms. The 2018 Act introduces the term “entity distribution” to refer to distributions from entities to which Section 401 applies and the term “capital distribution” to refer to

distributions of money, rather than other property, which nevertheless are treated as principal. “Capital distribution” replaces the former term “total or partial liquidation” and includes a “return of capital.”

Reinvested dividends. If a fiduciary elects (or continues an election made by a 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 making an adjustment from income to principal under Section 203. If the fiduciary makes or continues the election for a reason other than to comply with the standards of Section 203, such as making an investment without incurring brokerage commissions, the fiduciary has the option of considering a corresponding transfer of cash from principal to income.

Distribution of property. The 1962 Act described a number of types of property that would be principal if distributed by a corporation. This became unwieldy in a section (former Section 401) that applied to both corporations and all other entities. By stating that the distribution of any property other than money is generally allocated to principal, subsection (d)(1) 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. The new exception in subsections (c)(2) and (d)(1)(B) for “tangible personal property of nominal value” would cover, for example, an item of food sent to owners (and perhaps others such as customers, suppliers, and employees) at a holiday time. It is not necessarily given in proportion to ownership interests, and as a practical matter it often needs to be allocated to income, in effect, so it can be conveniently distributed and enjoyed.

With respect to large distributions of cash, the 2018 Act is sensitive to the fact that the fiduciary might not have enough information to properly categorize the distribution. Subsection (d)(2) addresses the relatively easy case of a likely non-pro-rata distribution that reduces the fiduciary’s proportionate interest in the entity – in effect, a redemption. Subsection (d)(4) retains the special rule for capital gain dividends from a regulated investment company (RIC) or real estate investment trust (REIT) that was added in 1997, and adds a reference to other distributions that federal income tax law treats comparably.

Subsection (d)(2) retains the rule that a distribution in exchange for part of all of the fiduciary’s interest in the entity is principal, but clarifies that this rule applies only to the extent the transaction reduces the fiduciary’s proportional interest in the entity relative to other owners. It does not necessarily apply, for example, to a corporate reorganization in which shareholders exchange their stock for other stock. If all owners receive proportionate distributions, the distribution to the fiduciary is tested as described in the next paragraph.

With regard to receipts of money that could be what the act refers to as a “capital distribution” – a return of capital or a distribution in partial liquidation of the entity – subsections (d)(3), (e), and (f) provide some help with what the act acknowledges might be only an “estimate” by the fiduciary. For this purpose, subsection (e) provides that the fiduciary may first rely on how the entity describes the distribution, unless the fiduciary possesses information that casts doubt on that description or the fiduciary is a majority voting owner, in which case the fiduciary may have a duty to inquire or investigate further. Next, the fiduciary may be satisfied

with treating the distribution as a capital distribution if information the entity provides, together with other information the fiduciary knows, indicates that the distribution exceeds 20 percent of the fair market value of the fiduciary's interest. This 20 percent test is retained from the 1997 Act, except that (i) it is a permissive safe harbor and not a presumption and (ii) the 1997 Act applied the 20 percent test to "the entity's gross assets" and the 2018 Act applies it to "the fair market value of the fiduciary's interest in the entity," thus focusing the inquiry on the distribution to that fiduciary rather than all distributions made by the entity. For this purpose, what the available information indicates is or will be a series of distributions is aggregated. Finally, under subsection (e)(3), the fiduciary may make a determination or estimate based on factors in subsection (f), including but not limited to the entity's characterization of the distribution, that may help point the fiduciary to a distribution that is extraordinary enough under the circumstances to be treated as a capital distribution. But it is not possible to describe a "capital distribution" with reference to objective characteristics alone, and fiduciaries will have to exercise some judgment in making the necessary determinations and estimates.

Because estimates may be necessary and are expressly contemplated by the act, subsections (h) and (i) help the fiduciary know how to make distributions on the basis of incomplete information and, as a last resort, cite the power to adjust between income and principal in Section 203.

SECTION 402. DISTRIBUTION FROM TRUST OR ESTATE. A fiduciary shall allocate to income an amount received as a distribution of income, including a unitrust distribution under [Article] 3, from a trust or estate in which the fiduciary has an interest, other than an interest the fiduciary purchased in a trust that is an investment entity, and shall allocate to principal an amount received as a distribution of principal from the trust or estate. If a fiduciary purchases, or receives from a settlor, an interest in a trust that is an investment entity, Section 401, 415, or 416 applies to a receipt from the trust.

Comment to 1997 Act

Terms of the distributing trust or estate. Under this section, a fiduciary is to allocate receipts in accordance with the terms of the recipient trust or, if there is no provision, in accordance with this act. In determining whether a distribution from another trust or an estate is income or principal, however, the fiduciary should also determine what the terms of the distributing trust or estate say about the distribution – for example, whether they direct that the distribution, even though made from the income of the distributing trust or estate, is to be added to principal of the recipient trust. Such a provision should override the terms of this act, but if the terms of the recipient trust contain a provision requiring such a distribution to be allocated to income, the trustee may have to obtain a judicial resolution of the conflict between the terms of the two documents.

Investment trusts. An investment entity to which the second sentence of this section applies includes a mutual fund, a common trust fund, a business trust, or other entity organized as a trust for the purpose of receiving capital contributed by investors, investing that capital, and managing investment assets, including asset-backed security arrangements or similar arrangements to which Section 415 or 416 applies. See John H. Langbein, *The Secret Life of the Trust: The Trust as an Instrument of Commerce*, 107 *Yale L.J.* 165 (1997).

SECTION 403. BUSINESS OR OTHER ACTIVITY CONDUCTED BY

FIDUCIARY.

(a) This section applies to a business or other activity conducted by a fiduciary if the fiduciary determines that it is in the interests of the beneficiaries to account separately for the business or other activity instead of:

(1) accounting for the business or other activity as part of the fiduciary's general accounting records; or

(2) conducting the business or other activity through an entity described in Section 401(a)(2)(A).

(b) A fiduciary may account separately under this section for the transactions of a business or other activity, whether or not assets of the business or other activity are segregated from other assets held by the fiduciary.

(c) A fiduciary that accounts separately under this section for a business or other activity:

(1) may determine:

(A) the extent to which the net cash receipts of the business or other activity must be retained for:

- (i) working capital;
- (ii) the acquisition or replacement of fixed assets; and
- (iii) other reasonably foreseeable needs of the business or other

activity; and

(B) the extent to which the remaining net cash receipts are accounted for as principal or income in the fiduciary's general accounting records for the trust;

(2) may make a determination under paragraph (1) separately and differently from the fiduciary's decisions concerning distributions of income or principal; and

(3) shall account for the net amount received from the sale of an asset of the business or other activity, other than a sale in the ordinary course of the business or other activity, as principal in the fiduciary's general accounting records for the trust, to the extent the fiduciary determines that the net amount received is no longer required in the conduct of the business or other activity.

(d) Activities for which a fiduciary may account separately under this section include:

- (1) retail, manufacturing, service, and other traditional business activities;
- (2) farming;
- (3) raising and selling livestock and other animals;
- (4) managing rental properties;
- (5) extracting minerals, water, and other natural resources;
- (6) growing and cutting timber;
- (7) an activity to which Section 414, 415, or 416 applies; and

(8) any other business conducted by the fiduciary.

Comment

Purpose and scope. Section 403 gives flexibility to a fiduciary who operates a business or other activity in proprietorship form rather than, for example, in a wholly-owned corporation or a single-member limited liability company, and enables the fiduciary to decide the extent to which the net receipts from the activity should be allocated to income, just as the board of directors of a corporation owned entirely by the trust would decide the amount of the annual dividend to be paid to the trust. It permits a fiduciary to account for farming or livestock operations, rental properties, oil and gas properties, timber operations, activities in derivatives and options, and other business activities as though they were held and conducted by a separate entity. Some of the wording of the descriptions of those business activities is changed to conform to the wording in subsequent sections that address those activities specifically, including Sections 405, 411, and 412. Section 403, however, does not permit a fiduciary to account separately for a traditional securities portfolio to avoid the provisions of this act that apply to such securities.

Section 403 permits the fiduciary to account separately for each business or activity for which the fiduciary determines separate accounting is appropriate. A fiduciary may account for these activities in a “subtrust” or may, for example, continue to use the business and record-keeping methods employed by a decedent or settlor who had conducted the business. This section gives the fiduciary broad authority to select business record-keeping methods that best suit the activity in which the fiduciary is engaged.

If a fiduciary liquidates a sole proprietorship or other activity to which Section 403 applies, the proceeds would be added to principal, even though derived from the liquidation of accounts receivable, because the proceeds would no longer be needed in the conduct of the business. If the liquidation occurs during probate or during an income interest’s winding up period, none of the proceeds would be income for purposes of Section 601.

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

Separate accounting. The 2018 Act adds subsection (c)(2) to the wording that was used in the 1997 Act to accommodate the concept of “separate accounting” in a trust the only activity of which (other than making distributions to beneficiaries) is the conduct of a business. It may not be reasonable to assume that receipts not distributed to beneficiaries have been “retained” for use in the business, if that permits discretionary distributions to beneficiaries, in effect, to define trust income. That might be especially awkward if discretionary distributions of either income or principal or both to multiple beneficiaries are not made pro rata. In such a case, the fiduciary is permitted to designate which distributions in effect define trust income, and which distributions are discretionary distributions under the terms of the trust not intended to be a standard or precedent for defining income.

[PART] 2

RECEIPTS NOT NORMALLY APPORTIONED

SECTION 404. PRINCIPAL RECEIPTS. A fiduciary shall allocate to principal:

(1) to the extent not allocated to income under this act, an asset received from:

(A) an individual during the individual's lifetime;

(B) an estate;

(C) a trust on termination of an income interest; or

(D) a payor under a contract naming the fiduciary as beneficiary;

(2) except as otherwise provided in this [article], money or other property received from the sale, exchange, liquidation, or change in form of a principal asset;

(3) an amount recovered from a third party to reimburse the fiduciary because of a disbursement described in Section 502(a) or for another reason to the extent not based on loss of income;

(4) proceeds of property taken by eminent domain, except that proceeds awarded for loss of income in an accounting period are income if a current income beneficiary had a mandatory income interest during the period;

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

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

Comment

Apportionment. Part 2, Receipts Not Normally Apportioned, generally addresses receipts that are either income or income, while Part 3, Receipts Normally Apportioned, generally addresses receipts that are "apportioned" part to income and part to principal. The act generally uses the term "allocate" to refer to both.

Reimbursements. The 1997 Act limited the application of paragraph (3) to reimbursements related to environmental matters described in Section 502(a)(8)(A), perhaps

because those are the disbursements listed in Section 502(a) that are most likely to be reimbursable. But they are not necessarily the only disbursements in Section 502(a) that could be reimbursed, and the 2018 Act cites only Section 502(a).

Eminent domain awards. Even though the award in an eminent domain proceeding may include an amount for the loss of future rent on a lease, if that amount is not separately stated the entire award is principal. This rule is the same in the 1931, 1962, and 1997 Acts.

SECTION 405. RENTAL PROPERTY. To the extent a fiduciary does not account for the management of rental property as a business under Section 403, the fiduciary shall allocate to income an amount received as rent of real or personal property, including an amount received for cancellation or renewal of a lease. An amount received as a refundable deposit, including a security deposit or a deposit that is to be applied as rent for future periods:

(1) must be added to principal and held subject to the terms of the lease, except as otherwise provided by law other than this act; and

(2) is not allocated to income or available for distribution to a beneficiary until the fiduciary's contractual obligations have been satisfied with respect to that amount.

Comment

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 505 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 203 in deciding whether and to what extent to make an adjustment between principal and income under Section 203.

Available for distribution. The term "available for distribution to a beneficiary" in paragraph (2), which the 2018 Act carries over from the 1997 Act, does not mean "allocated to income." That would be inconsistent with the requirement earlier in the sentence, also carried over from the 1997 Act, that the receipt "must be added to principal." To make that clear, the words "allocated to income or" are added in the 2018 Act before "available for distribution." The concept is that deposits are held in the trust corpus, but will be allocated to income if and when the tenant has the right to ask, and does ask, for those funds to be applied to future rent. In any event, the applicable precondition – whether for application of the deposit to rent payments, return of the deposit to the tenant, or allocation to income upon the tenant's forfeiture – is the satisfaction of the fiduciary's contractual obligations with respect to that deposit, namely to hold

it until an objectively determined event or time.

SECTION 406. RECEIPT ON OBLIGATION TO BE PAID IN MONEY.

(a) This section does not apply to an obligation to which Section 409, 410, 411, 412, 414, 415, or 416 applies.

(b) A fiduciary shall allocate to income, without provision for amortization of premium, an amount received as interest on an obligation to pay money to the fiduciary, including an amount received as consideration for prepaying principal.

(c) A fiduciary shall allocate to principal an amount received from the sale, redemption, or other disposition of an obligation to pay money to the fiduciary. A fiduciary shall allocate to income the increment in value of a bond or other obligation for the payment of money bearing no stated interest but payable or redeemable, at maturity or another future time, in an amount that exceeds the amount in consideration of which it was issued.

Comment

Section 406 in the 2018 Act is largely similar to Section 406 in the 1997 Act, except that Section 406(c) is reworded to follow New York's statute (EPTL §11-A-4.6).

SECTION 407. INSURANCE POLICY OR CONTRACT.

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

(b) Except as otherwise provided in subsection (c), a fiduciary shall allocate to principal the proceeds of a life insurance policy or other contract received by the fiduciary as beneficiary, including a contract that insures against damage to, destruction of, or loss of title to an asset. The fiduciary shall allocate dividends on an insurance policy to income to the extent premiums on the policy are paid from income and to principal to the extent premiums on the policy are paid from principal.

(c) A fiduciary shall allocate to income proceeds of a contract that insures the fiduciary

against loss of:

- (1) occupancy or other use by a current income beneficiary;
- (2) income; or
- (3) subject to Section 403, profits from a business.

[PART] 3

RECEIPTS NORMALLY APPORTIONED

SECTION 408. INSUBSTANTIAL ALLOCATION NOT REQUIRED.

(a) If a fiduciary determines that an allocation between income and principal required by Section 409, 410, 411, 412, or 415 is insubstantial, the fiduciary may allocate the entire amount to principal, unless Section 203(e) applies to the allocation.

(b) A fiduciary may presume an allocation is insubstantial under subsection (a) if:

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

(2) the asset producing the receipt to be allocated has a fair market value less than 10 percent of the total fair market value of the assets owned or held by the fiduciary at the beginning of the accounting period.

(c) The power to make a determination under subsection (a) may be:

(1) exercised by a co-fiduciary in the manner described in Section 203(f); or

(2) released or delegated for a reason described in Section 203(g) and in the manner described in Section 203(h).

Comment

The 2018 Act retains Section 408 from the 1997 Act, excusing a fiduciary from the burden of determining the portion of a receipt that should be allocated to income if the allocation would be “insubstantial.” A fiduciary might determine that an allocation would be “insubstantial,” for example, if the cost of determining the amount of the allocation would be greater than the economic effect of the allocation, or if such an allocation each year would create

a variability or unpredictability of the income stream that would offset any apparent precision that the allocation might achieve.

Section 408(b) creates a safe harbor, within which a fiduciary may presume an allocation to be insubstantial. In the 1997 Act, paragraphs (1) and (2) of subsection (b) were joined by the conjunction “or.” The 2018 Act tightens up the resulting test, making it somewhat less generous by changing the conjunction to “and.” As a practical matter, a fiduciary will have to estimate such things and in a close case is not likely to know with certainty the parameters of subsection (b) until after the end of the accounting period. But if the upper limits escape precision, or are not even viewed as very important because most allocations viewed as insubstantial are well within the limits, a fiduciary that simply does not bother with a small amount here and there is protected.

The reference to Section 203(e) in Section 408(a) and the reference to Section 408 in Section 203(e) mean that allocations cannot be overlooked under Section 408 if to do so would create a tax issue or achieve another result listed in Section 203(e) or if the fiduciary is not an independent person defined in Section 102(11).

Subsection (c) is drawn from the 1997 Act, except that delegation is added to release as an option under paragraph (2).

SECTION 409. DEFERRED COMPENSATION, ANNUITY, OR SIMILAR

PAYMENT.

(a) In this section:

(1) “Internal income of a separate fund” means the amount determined under subsection (b).

(2) “Marital trust” means a trust:

(A) of which the settlor’s surviving spouse is the only current income beneficiary and is entitled to a distribution of all the current net income of the trust; and

(B) that qualifies for a marital deduction with respect to the settlor’s estate under Section 2056 of the Internal Revenue Code of 1986^[, as amended,], 26 U.S.C. Section 2056^[, as amended,] because:

(i) an election to qualify for a marital deduction under Section 2056(b)(7) of the Internal Revenue Code of 1986^[, as amended,], 26 U.S.C. Section 2056(b)(7)^[,]

~~as amended,~~ has been made; or

(ii) the trust qualifies for a marital deduction under Section 2056(b)(5) of the Internal Revenue Code of 1986~~, as amended,~~ 26 U.S.C. Section 2056(b)(5)~~, as amended~~.

(3) "Payment" means an amount a fiduciary 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 payor in exchange for future amounts the fiduciary may receive. The term includes an amount received in money or property from the payor's general assets or from a separate fund created by the payor.

(4) "Separate fund" includes a private or commercial annuity, an individual retirement account, and a pension, profit-sharing, stock-bonus, or stock-ownership plan.

(b) For each accounting period, the following rules apply to a separate fund:

(1) The fiduciary shall determine the internal income of the separate fund as if the separate fund were a trust subject to this act.

(2) If the fiduciary cannot determine the internal income of the separate fund under paragraph (1), the internal income of the separate fund is deemed to equal ~~insert a number~~ ~~at least three and not more than five~~ four percent of the value of the separate fund, according to the most recent statement of value preceding the beginning of the accounting period.

(3) If the fiduciary cannot determine the value of the separate fund under paragraph (2), the value of the separate fund is deemed to equal the present value of the expected future payments, as determined under Section 7520 of the Internal Revenue Code of 1986~~, as amended,~~ 26 U.S.C. Section 7520~~, as amended~~, for the month preceding the beginning of the accounting period for which the computation is made.

(c) A fiduciary shall allocate a payment received from a separate fund during an accounting period to income, to the extent of the internal income of the separate fund during the period, and the balance to principal.

(d) The fiduciary of a marital trust shall:

(1) withdraw from a separate fund the amount the current income beneficiary of the trust requests the fiduciary to withdraw, not greater than the amount by which the internal income of the separate fund during the accounting period exceeds the amount the fiduciary otherwise receives from the separate fund during the period;

(2) transfer from principal to income the amount the current income beneficiary requests the fiduciary to transfer, not greater than the amount by which the internal income of the separate fund during the period exceeds the amount the fiduciary receives from the separate fund during the period after the application of paragraph (1); and

(3) distribute to the current income beneficiary as income:

(A) the amount of the internal income of the separate fund received or withdrawn during the period; and

(B) the amount transferred from principal to income under paragraph (2).

(e) For a trust, other than a marital trust, of which one or more current income beneficiaries are entitled to a distribution of all the current net income, the fiduciary shall transfer from principal to income the amount by which the internal income of a separate fund during the accounting period exceeds the amount the fiduciary receives from the separate fund during the period.

Legislative Note: A United States Code citation (U.S.C.) follows a reference to the federal Internal Revenue Code in subsections (a)(2)(B) and (b)(3). The United States Code citation is included as an aid to the reader. If the state's convention is to omit the United States Code citation, simply delete the United States Code citation. In states in which the constitution, or

other law, does not permit the phrase “as amended” when federal statutes are incorporated into state law, the phrase should be omitted.

The bracketed words in subsection (b)(2) should be replaced with a percentage that fiduciaries may rely on as a “safe harbor”. The 2008 revision to the Uniform Principal and Income Act used the range of three to five percent because the Internal Revenue Service approved the use of that range in the context of unitrusts. See Treasury Reg. Section 1.643(b)-1.

Comment

Section 409 of the 1997 Act was substantially amended in 2008 in response to concerns expressed by the Internal Revenue Service about the eligibility of a transfer of an individual retirement account (IRA) or other qualified retirement benefit to a marital trust intended to qualify for an estate tax marital deduction. See Revenue Ruling 2006-26, 2006-22 Internal Revenue Bulletin 939.

The 2018 Act further revises and simplifies Section 409. Former general subsections (b) and (c) are omitted, leaving marital trusts as the focus. The 2018 Act treats marital trusts and other trusts the same, except as provided in subsection (e).

Current subsection (b)(1) is similar to the first sentence of former subsection (f) relating to the determination of the internal income of what is called in both acts a “separate fund” (such as an IRA), and current subsection (b)(2) and (3) is similar to former subsection (g) relating to the determination of data to use if the fiduciary cannot determine the internal income or the value of the separate fund.

Former subsection (f) provided in full:

(f) A trustee shall determine the internal income of each separate fund for the accounting period as if the separate fund were a trust subject to this [act]. Upon request of the surviving spouse, the trustee shall demand that the person administering the separate fund distribute the internal income to the trust. The trustee shall allocate a payment from the separate fund to income to the extent of the internal income of the separate fund and distribute that amount to the surviving spouse. The trustee shall allocate the balance of the payment to principal. Upon request of the surviving spouse, the trustee shall allocate principal to income to the extent the internal income of the separate fund exceeds payments made from the separate fund to the trust during the accounting period.

Subsection (d) of the 2018 Act reaches the same result to satisfy the concerns of Revenue Ruling 2006-26, but clarifies the ordering and interrelationships of the respective provisions. Subsection (d) prescribes what the fiduciary is required to do if the settlor’s surviving spouse requests. It does not limit the fiduciary’s discretion to make withdrawals from the separate fund in excess of what the spouse requests or in excess of the internal income of the fund.

For a trust that is not a marital trust but is required to distribute current income, subsection (e) requires the fiduciary to transfer principal to income to make up for the amount of the internal income of an IRA or similar fund that is not withdrawn. But it is silent on whether the fiduciary should withdraw greater amounts from the fund, leaving that to the fiduciary’s

discretion guided by general fiduciary standards such as the standards set forth in Section 201(a).

SECTION 410. LIQUIDATING ASSET.

(a) In this section, “liquidating asset” means an asset whose value will diminish or terminate because the asset is expected to produce receipts for a limited time. The term includes a leasehold, patent, copyright, royalty right, and right to receive payments during a period of more than one year under an arrangement that does not provide for the payment of interest on the unpaid balance.

(b) This section does not apply to a receipt subject to Section 401, 409, 411, 412, 414, 415, 416, or 503.

(c) A fiduciary shall allocate:

(1) to income:

(A) a receipt produced by a liquidating asset, to the extent the receipt does not exceed ~~insert a number at least three and not more than five~~ four percent of the value of the asset; or

(B) if the fiduciary cannot determine the value of the asset, 10 percent of the receipt; and

(2) to principal, the balance of the receipt.

Legislative Note: *The bracketed words in subsection (c)(1)(A) should be replaced with a percentage that fiduciaries may rely on as a “safe harbor”. The 2008 revision to the Uniform Principal and Income Act used the range of three to five percent because the Internal Revenue Service approved the use of that range in the context of unitrusts. See Treasury Reg. Section 1.643(b)-1.*

Comment

Previous Acts. As stated in a Comment to the 1997 Act, Section 11 of the 1962 Act allocated receipts from “property subject to depletion” to income in an amount “not in excess of 5%” of the asset’s inventory value. The 1931 Act had a similar 5-percent rule that applied when the trustee was under a duty to change the form of the investment. The 5-percent rule imposed on a fiduciary the obligation to pay a fixed annuity to the current income beneficiary until the asset

was exhausted. Under both the 1931 and 1962 Acts, the balance of each year's receipts was added to principal.

A fixed payment can produce results that appear unfair. The remainder beneficiary receives all of the receipts from unexpected growth in the asset, e.g., if royalties on a patent or copyright increase significantly. Conversely, if the receipts diminish more rapidly than expected, most of the amount received by the trust will be allocated to income and little to principal. Moreover, if the annual payments remain the same for the life of the asset, the amount allocated to principal will usually be less than the original inventory value. For these reasons, Section 410 of the 1997 Act abandoned the annuity approach of the 5-percent rule, but required that 10 percent of the receipts from a "liquidating asset" be allocated to income and the balance to principal. The 2018 Act restores a variation of the annuity approach, with a range of 3 to 5 percent of the value of the asset consistent with other provisions in the act, and retains the 10-percent-of-the-receipt rule for cases where the fiduciary cannot determine the value of the asset.

SECTION 411. MINERALS, WATER, AND OTHER NATURAL RESOURCES.

(a) To the extent a fiduciary does not account for a receipt from an interest in minerals, water, or other natural resources as a business under Section 403, the fiduciary shall allocate the receipt:

(1) to income, to the extent received:

(A) as delay rental or annual rent on a lease;

(B) as a factor for interest or the equivalent of interest under an agreement

creating a production payment; or

(C) on account of an interest in renewable water;

(2) to principal, if received from a production payment, to the extent paragraph

(1)(B) does not apply; or

(3) between income and principal equitably, to the extent received:

(A) on account of an interest in non-renewable water;

(B) as a royalty, shut-in-well payment, take-or-pay payment, or bonus; or

(C) from a working interest or any other interest not provided for in

paragraph (1) or (2) or subparagraph (A) or (B).

(b) This section applies to an interest owned or held by a fiduciary whether or not a settlor was extracting minerals, water, or other natural resources before the fiduciary owned or held the interest.

(c) An allocation of a receipt under subsection (a)(3) is presumed to be equitable if the amount allocated to principal is equal to the amount allowed by the Internal Revenue Code of 1986~~[, as amended,]~~, 26 U.S.C.~~[, as amended,]~~, as a deduction for depletion of the interest.

(d) If a fiduciary owns or holds an interest in minerals, water, or other natural resources before [the effective date of this act], the fiduciary may allocate receipts from the interest as provided in this section or in the manner used by the fiduciary before [the effective date of this act]. If the fiduciary acquires an interest in minerals, water, or other natural resources on or after [the effective date of this act], the fiduciary shall allocate receipts from the interest as provided in this section.

***Legislative Note:** A United States Code citation (U.S.C.) follows a reference to the federal Internal Revenue Code in subsection (c). The United States Code citation is included as an aid to the reader. If the state's convention is to omit the United States Code citation, simply delete the United States Code citation. In states in which the constitution, or other law, does not permit the phrase "as amended" when federal statutes are incorporated into state law, the phrase should be omitted.*

Comment

The 2018 Act adapts Section 411 from the Texas statute (Texas Trust Code Sec. 116.174). It is similar to Section 411 of the 1997 Act, except that it does not provide for a default 10-percent allocation to income, but provides that the allocation should be made "equitably," and then provides, in subsection (c), that an allocation to principal of the amount allowed by the Internal Revenue Code as a depletion deduction is presumed to be equitable. For oil and gas percentage depletion, that percentage has most recently been set at 15 percent. Cost depletion for federal income tax purposes is also available as a safe harbor. Subsection (d) will protect a fiduciary that is currently relying on the 10-percent rule.

In contrast to the 1997 Act, the 2018 Act changes the reference to "on the effective date of this act" at the beginning of the first sentence of Section 411(d) to "before the effective date of this act" to conform to that reference in the last part of that sentence. Similarly, the 2018 Act changes the reference to "after the effective date of this act" in the second sentence of Section 411(d) to "on or after the effective date of this act" to make the two sentences complementary.

SECTION 412. TIMBER.

(a) To the extent a fiduciary does not account for receipts from the sale of timber and related products as a business under Section 403, the fiduciary shall allocate the net receipts:

(1) to income, to the extent the amount of timber cut from the land does not exceed the rate of growth of the timber;

(2) to principal, to the extent the amount of timber cut from the land exceeds the rate of growth of the timber or the net receipts are from the sale of standing timber;

(3) between income and principal if the net receipts are from the lease of land used for growing and cutting timber or from a contract to cut timber from land, by determining the amount of timber cut from the land under the lease or contract and applying the rules in paragraphs (1) and (2); or

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

(b) In determining net receipts to be allocated under subsection (a), a fiduciary shall deduct and transfer to principal a reasonable amount for depletion.

(c) This section applies to land owned or held by a fiduciary whether or not a settlor was cutting timber from the land before the fiduciary owned or held the property.

(d) If a fiduciary owns or holds an interest in land used for growing and cutting timber before [the effective date of this act], the fiduciary may allocate net receipts from the sale of timber and related products as provided in this section or in the manner used by the fiduciary before [the effective date of this act]. If the fiduciary acquires an interest in land used for growing and cutting timber on or after [the effective date of this act], the fiduciary shall allocate net receipts from the sale of timber and related products as provided in this section.

Comment

Section 412 is substantially the same in the 2018 Act as in the 1997 Act, except for changes in wording to conform to wording used through the act. In addition, in contrast to the 1997 Act, as in Section 411(d), the 2018 Act changes the reference to “on the effective date of this act” at the beginning of the first sentence of Section 412(d) to “before the effective date of this act” to conform to that reference in the last part of that sentence, and changes the reference to “after the effective date of this act” in the second sentence of Section 412(d) to “on or after the effective date of this act” to make the two sentences complementary.

Although the previous acts do not have sections addressing every context where things are grown – for example, agriculture, orchards, and cattle and poultry raising – in the way they address timber, a fiduciary may be able to adapt the principles applicable to timber to those other contexts, including the contexts of activities accounted for separately as businesses, as specified in Section 403(d)(2) and (3).

Comment to 1997 Act

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

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

SECTION 413. MARITAL DEDUCTION PROPERTY NOT PRODUCTIVE OF INCOME.

(a) If a trust received property for which a gift or estate tax marital deduction was allowed and the settlor's spouse holds a mandatory income interest in the trust, the spouse may require the trustee, to the extent the trust assets otherwise do not provide the spouse with sufficient income from or use of the trust assets to qualify for the deduction, to:

- (1) make property productive of income;
- (2) convert property to property productive of income within a reasonable time; or
- (3) exercise the power to adjust under Section 203.

(b) The trustee may decide which action or combination of actions in subsection (a) to take.

Comment

In Section 413 the 2018 Act makes little substantive change from the 1997 Act. It omits Section 413(b) of the 1997 Act, which had provided:

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

Section 404(2) of the 2018 Act provides that proceeds from a sale or exchange of a principal asset remain principal, which renders former Section 413(b) duplicative.

SECTION 414. DERIVATIVE OR OPTION.

(a) In this section, "derivative" means a contract, instrument, other arrangement, or combination of contracts, instruments, or other arrangements, the value, rights, and obligations of which are, in whole or in part, dependent on or derived from an underlying tangible or intangible asset, group of tangible or intangible assets, index, or occurrence of an event. The term includes stocks, fixed income securities, and financial instruments and arrangements based on indices, commodities, interest rates, weather-related events, and credit-default events.

(b) To the extent a fiduciary does not account for a transaction in derivatives as a business under Section 403, the fiduciary shall allocate 10 percent of receipts from the transaction and 10 percent of disbursements made in connection with the transaction to income and the balance to principal.

(c) Subsection (d) applies if:

(1) a fiduciary:

(A) grants an option to buy property from a trust, whether or not the trust owns the property when the option is granted;

(B) grants an option that permits another person to sell property to the trust; or

(C) acquires an option to buy property for the trust or an option to sell an asset owned by the trust; and

(2) the fiduciary or other owner of the asset is required to deliver the asset if the option is exercised.

(d) If this subsection applies, the fiduciary shall allocate 10 percent to income and the balance to principal of the following amounts:

(1) an amount received for granting the option;

(2) an amount paid to acquire the option; and

(3) gain or loss realized on the exercise, exchange, settlement, offset, closing, or expiration of the option.

Comment

Section 414 in the 1997 Act provided that all receipts and disbursements from a derivative and option must be allocated to principal.

In the 2018 Act, the definition of “derivative” includes some of the most common current derivatives, including: (1) options, which provide one party the right but not the obligation to

buy or sell the underlying asset at a set price, (2) forwards and futures contracts, which obligate one party to buy or sell the underlying asset at a set price in the future, and (3) swaps (sometimes referred to as “notional principal contracts”), which obligate both parties to the arrangement to make payments to the other party based on the change in value of an underlying asset or the occurrence of an event. The definition is broad enough to include less common derivatives like exchange-traded notes (financial instruments traded on an exchange, the values of which are linked to the returns of hypothetical investments in specified market indices or strategies), structured or principal-protected notes (financial instruments typically issued by a financial organization that provide the holder some principal protection along with a return based on the return of an underlying asset like a stock index), and derivatives that could be created in the future. The definition does not make a distinction between derivatives that are privately negotiated between a party and counterparty and those that are traded on an exchange or in the over-the-counter market. Although options technically fall within the definition of derivative, as in the 1997 Act a specific subsection makes clear that any amounts paid to or received by the fiduciary in the granting of an option and any gain or loss upon any realization or expiration event will be allocated to income and principal in the same manner.

The 2018 Act does not include a suggested provision that would have asked the fiduciary, in allocating receipts or disbursements under a derivative contract to income or principal, to consider how they would be allocated if the fiduciary had invested directly in the underlying asset that is the subject of the derivative. For example, if a fiduciary entered into a total return equity swap on shares of ABC stock, pursuant to which the fiduciary would receive payments from the counterparty due to any dividends and appreciation on ABC stock, then the fiduciary would have been asked to allocate to income that portion of the return that is due to dividends and to principal that portion of the return that is due to appreciation of ABC stock. That sort of determination, however, would work only for the simplest of derivative arrangements. Derivatives allow parties to take positions in assets that would not be possible under an established market and to make highly leveraged investments in assets that would not be permitted under current margin regulations. Furthermore, derivatives are sometimes combined in such a way that looking through to the underlying asset is difficult or impossible. For example, a “swaption” is an option that provides the owner the right to enter into a swap. Because of these complications, the 2018 Act provides a default rule that provides that all receipts and disbursements in relation to a derivative transaction should be allocated 10 percent to income and 90 percent to principal. No distinction is made if the fiduciary establishes a long position (generally seeking to profit from an increase in value of the underlying asset) or short position (seeking to profit from a decrease in value of the underlying asset) with the derivative.

This default allocation for derivatives can be adjusted pursuant to the fiduciary’s power to adjust between income and principal under Section 203. In making that determination, the fiduciary can consider whether the default rule would not be fair and reasonable, especially in light of the fact that derivatives can be used to create the equivalent return as another investment, whose allocation under the act might be different from the default rule. For example, in a traditional total return equity swap, one party (Party S, for Short) agrees to make annual payments over the next 5 years in an amount equal to the sum of the total appreciation in value of 100 shares of XYZ stock during the year, and dividends paid on 100 shares of XYZ stock during the year. The counterparty (Party L, for Long) agrees to make five annual payments (at the same time) in an amount equal to the total depreciation in value of 100 shares of XYZ stock

during the year, and a fixed rate of interest multiplied by the value of 100 shares of XYZ stock at the beginning of each year. The amounts are netted against each other. From an economic standpoint, Party L is in the same situation it would have been in if Party L had borrowed funds from Party S and used those proceeds to buy 100 shares of XYZ shares from Party S, with an agreement to sell the shares back to Party S at the end of the 5 year period (100-percent-leveraged investment in 100 shares of XYZ shares).

Furthermore, the fiduciary should consider whether the derivative is being used as a way to hedge or manage risk on another investment, and, as such, any receipts or disbursements on the derivative should be combined with the hedged investment. For example, an investor may have an investment (ABC stock) and use a derivative to hedge against a decrease in the investment's value (buy a put option on ABC stock). The fiduciary should consider whether the cost or return on the put option is properly combined with the cost or return on ABC stock in applying the default rule or making any adjustments to income or principal as to ABC stock.

As another example, the most common swap arrangement is an interest rate swap, pursuant to which parties help manage the impact of changes in interest rates on investments in the portfolio and liabilities associated with loans. In a common interest rate swap (floating-to-fixed rate), one party agrees to make payments based on a fixed interest rate (for example, 5 percent) applied to a notional amount (for example, \$1 million) at regular intervals (for example, quarterly for two years). The counterparty agrees to make interest payments based on a floating or variable rate of interest (for example, 3 percent above the London Interbank Offered Rate [LIBOR]) applied to the same notional amount. An interest rate swap like this can reflect one party's expectation that the payments of a floating interest rate will exceed a specified fixed interest rate (or vice versa). Importantly, to the extent such party has a loan or other liability tied to a floating interest rate, the party might be seeking to hedge against the risk of an interest rate increase by essentially converting the liability to a fixed rate liability. In deciding whether to use the default rule or exercise the power to adjust, the fiduciary may decide, if appropriate, based on the facts and circumstances, to apply the default rule as to the interest rate swap in isolation or as part of a larger transaction where the swap should be considered in conjunction with a larger transaction, liability, or investment.

SECTION 415. ASSET-BACKED SECURITY.

(a) Except as otherwise provided in subsection (b), a fiduciary shall allocate to income a receipt from or related to an asset-backed security, to the extent the payor identifies the payment as being from interest or other current return, and to principal the balance of the receipt.

(b) If a fiduciary receives one or more payments in exchange for part or all of the fiduciary's interest in an asset-backed security, including a liquidation or redemption of the fiduciary's interest in the security, the fiduciary shall allocate to income 10 percent of receipts

from the transaction and 10 percent of disbursements made in connection with the transaction, and to principal the balance of the receipts and disbursements.

Comment

The primary changes to Section 415 in the 2018 Act include a more inclusive definition of an asset-backed security that is in line with the definition used by the Securities and Exchange Commission. The allocation retains the distinction between payments of interest and principal, for example on a mortgage. Subsection (b) is simply a blanket rule of a 10-percent allocation for any sales of a portion or all of the interest in the asset-backed security (consistently with Section 414). This rule applies to sales of the asset-backed security on an exchange or a redemption/liquidation of the interest.

SECTION 416. OTHER FINANCIAL INSTRUMENT OR ARRANGEMENT. A

fiduciary shall allocate receipts from or related to a financial instrument or arrangement not otherwise addressed by this act. The allocation must be consistent with Sections 414 and 415.

Comment

The 2018 Act adds Section 416 to provide guidance for financial instruments and arrangements designed in the future, which could not be anticipated in advance. References to Section 416, as appropriate, are added throughout the 2018 Act where there are references to Sections 414 and 415.

[ARTICLE] 5

ALLOCATION OF DISBURSEMENTS

SECTION 501. DISBURSEMENT FROM INCOME. Subject to Section 504, and except as otherwise provided in Section 601(c)(2) or (3), a fiduciary shall disburse from income:

(1) one-half of:

(A) the regular compensation of the fiduciary and any person providing investment advisory, custodial, or other services to the fiduciary, to the extent income is sufficient; and

(B) an expense for an accounting, judicial or nonjudicial proceeding, or other matter that involves both income and successive interests, to the extent income is sufficient;

(2) the balance of the disbursements described in paragraph (1), to the extent a fiduciary

that is an independent person determines that making those disbursements from income would be in the interests of the beneficiaries;

(3) another ordinary expense incurred in connection with administration, management, or preservation of property and distribution of income, including interest, an ordinary repair, regularly recurring tax assessed against principal, and an expense of an accounting, judicial or nonjudicial proceeding, or other matter that involves primarily an income interest, to the extent income is sufficient; and

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

Comment

Although the 2018 Act updates the choice of words and word order to match more recent usage, there are few substantive changes in Article 5.

The phrase “to the extent income is sufficient” is added at the end of Section 501(1)(A) and (B) and (3) to acknowledge and accommodate illiquid, low-income-producing trusts. And, as that phrase protects income, paragraph (2) protects principal by allowing more than one-half of the disbursements described in this section to be paid from income. One reason, for example, would be that principal is illiquid. Reimbursements under Sections 504 and 505 may be available.

SECTION 502. DISBURSEMENT FROM PRINCIPAL.

(a) Subject to Section 505, and except as otherwise provided in Section 601(c)(2), a fiduciary shall disburse from principal:

(1) the balance of the disbursements described in Section 501(1) and (3), after application of Section 501(2);

(2) the fiduciary’s compensation calculated on principal as a fee for acceptance, distribution, or termination;

(3) a payment of an expense to prepare for or execute a sale or other disposition of property;

(4) a payment on the principal of a trust debt;

(5) a payment of an expense of an accounting, judicial or nonjudicial proceeding, or other matter that involves primarily principal, including a proceeding to construe the terms of the trust or protect property;

(6) a payment of a premium for insurance, including title insurance, not described in Section 501(4), of which the fiduciary is the owner and beneficiary;

(7) a payment of an estate or inheritance tax or other tax imposed because of the death of a decedent, including penalties, apportioned to the trust; and

(8) a payment:

(A) related to environmental matters, including:

(i) reclamation;

(ii) assessing environmental conditions;

(iii) remedying and removing environmental contamination;

(iv) monitoring remedial activities and the release of substances;

(v) preventing future releases of substances;

(vi) collecting amounts from persons liable or potentially liable for the costs of activities described in clauses (i) through (v);

(vii) penalties imposed under environmental laws or regulations;

(viii) other actions to comply with environmental laws or regulations;

(ix) statutory or common law claims by third parties; and

(x) defending claims based on environmental matters; and

(B) for a premium for insurance for matters described in subparagraph

(A).

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

Comment

The 2018 Act replaces “the remaining one-half” at the beginning of Section 502(a)(1) in the 1997 Act with “the balance.” This conforms to the changes to Section 501 that make it more likely that traditional 50-50 splits will not necessarily be followed. Reimbursements under Sections 504 and 505 may be available. A reference to title insurance is added to Section 502(a)(6).

The 1997 Act added the detailed provisions regarding environmental remediation in what is now Section 502(a)(8)(A). The 2018 Act adds to those provisions a reference in subparagraph (B) to insurance premiums.

SECTION 503. TRANSFER FROM INCOME TO PRINCIPAL FOR DEPRECIATION.

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

(b) A fiduciary may transfer to principal a reasonable amount of the net cash receipts from a principal asset that is subject to depreciation, but may not transfer any amount for depreciation:

(1) of the part of real property used or available for use by a beneficiary as a residence;

(2) of tangible personal property held or made available for the personal use or enjoyment of a beneficiary; or

(3) under this section, to the extent the fiduciary accounts:

(A) under Section 410 for the asset; or

(B) under Section 403 for the business or other activity in which the asset is used.

(c) An amount transferred to principal under this section need not be separately held.

Comment

The 2018 Act changes “fixed” to “tangible” in the definition of depreciation in Section 503(a). The references to “a residence” and “tangible personal property” in Section 503(b)(1) are broken up into paragraphs (1) and (2), for ease of reading, and to avoid implying that the two topics are linked so that, for example, the tangible personal property described must be household furnishings. The 2018 Act also adds Section 503(b)(3)(A) to expand the exception from the depreciation rule to assets accounted for separately as liquidating assets under Section 410, as well in a business under Section 403.

SECTION 504. REIMBURSEMENT OF INCOME FROM PRINCIPAL.

(a) If a fiduciary makes or expects to make an income disbursement described in subsection (b), the fiduciary may transfer an appropriate amount from principal to income in one or more accounting periods to reimburse income.

(b) To the extent the fiduciary has not been and does not expect to be reimbursed by a third party, income disbursements to which subsection (a) applies include:

(1) an amount chargeable to principal but paid from income because principal is illiquid;

(2) a disbursement made to prepare property for sale, including improvements and commissions; and

(3) a disbursement described in Section 502(a).

(c) If an asset whose ownership gives rise to an income disbursement becomes subject to a successive interest after an income interest ends, the fiduciary may continue to make transfers under subsection (a).

Comment

Section 504, Transfers from Income to Reimburse Principal, in the 1997 Act is redesignated Section 505, Reimbursement of Principal from Income, in the 2018 Act. New Section 504, Reimbursement of Income from Principal, is the mirror image of Section 505, with the result that reimbursements in both directions are now covered in the same way. Cross-references to these sections are added at the beginning of Sections 501 and 502. The order of Sections 504 and 505 was selected with reference to the corresponding Sections 501 and 502. Section 501 is “Subject to Section 504,” and Section 502 is “Subject to Section 505.”

The term “successive income interest” in Section 504(c) of the 1997 Act is changed to simply “successive interest” in Sections 504(c) and 505(c) of the 2018 Act, because that is now the defined term in Section 102(20). Even though a “successive interest” includes the interest of a person entitled to receive principal – that is, a remainder beneficiary – when an income interest ends, that does not mean that Section 504 or 505 would continue to apply after a trust terminates, because the terms of the trust providing for termination would control under Section 201(a)(3).

SECTION 505. REIMBURSEMENT OF PRINCIPAL FROM INCOME.

(a) If a fiduciary makes or expects to make a principal disbursement described in subsection (b), the fiduciary may transfer an appropriate amount from income to principal in one or more accounting periods to reimburse principal or provide a reserve for future principal disbursements.

(b) To the extent a fiduciary has not been and does not expect to be reimbursed by a third party, principal disbursements to which subsection (a) applies include:

(1) an amount chargeable to income but paid from principal because income is not sufficient;

(2) the cost of an improvement to principal, whether a change to an existing asset or the construction of a new asset, including a special assessment;

(3) a disbursement made to prepare property for rental, including tenant allowances, leasehold improvements, and commissions;

(4) a periodic payment on an obligation secured by a principal asset, to the extent the amount transferred from income to principal for depreciation is less than the periodic

payment; and

(5) a disbursement described in Section 502(a).

(c) If an asset whose ownership gives rise to a principal disbursement becomes subject to a successive interest after an income interest ends, the fiduciary may continue to make transfers under subsection (a).

SECTION 506. INCOME TAXES.

(a) A tax required to be paid by a fiduciary which is based on receipts allocated to income must be paid from income.

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

(c) Subject to subsection (d) and Sections 504, 505, and 507, a tax required to be paid by a fiduciary on a share of an entity's taxable income in an accounting period must be paid from:

(1) income and principal proportionately to the allocation between income and principal of receipts from the entity in the period; and

(2) principal to the extent the tax exceeds the receipts from the entity in the period.

(d) After applying subsections (a) through (c), a fiduciary shall adjust income or principal receipts, to the extent the taxes the fiduciary pays are reduced because of a deduction for a payment made to a beneficiary.

Comment

Marital deduction issues. Any payment of income tax from income could raise issues of the estate or gift tax marital deduction, especially if the income on which that income tax is paid is not fully distributed, as in the case of income retained in an entity owned in whole or in part by the trust. These issues are similar to the issues raised by Revenue Ruling 2006-26 in the context of defined contribution qualified retirement plans and individual retirement accounts (IRAs). See

Section 409 and the Comment thereto. The 2018 Act makes no change to Section 506 because the power in the spouse to cause the trust assets to be made reasonably productive of income addresses any marital deduction issue. See Section 413.

Comment to 2008 Amendments of 1997 Act

Taxes on Undistributed Entity Taxable Income. When a nongrantor trust owns an interest in a pass-through entity, such as a partnership or S corporation, it must report its share of the entity's taxable income regardless of how much the entity distributes to the trust. Whether the entity distributes more or less than the trust's tax on its share of the entity's taxable income, the trust must pay the taxes and allocate them between income and principal.

Subsection (c) requires the trust to pay the taxes on its share of an entity's taxable income from income or principal receipts to the extent that receipts from the entity are allocable to each. This assures the trust a source of cash to pay some or all of the taxes on its share of the entity's taxable income. Subsection (d) recognizes that, except in the case of an Electing Small Business Trust (ESBT), a trust normally receives a deduction for amounts distributed to a beneficiary. Accordingly, subsection (d) requires the trust to increase receipts payable to a beneficiary as determined under subsection (c) to the extent the trust's taxes are reduced by distributing those receipts to the beneficiary.

Because the trust's taxes and amounts distributed to a beneficiary are interrelated, the trust may be required to apply a formula to determine the correct amount payable to a beneficiary. This formula should take into account that each time a distribution is made to a beneficiary, the trust taxes are reduced and amounts distributable to a beneficiary are increased. The formula assures that after deducting distributions to a beneficiary, the trust has enough to satisfy its taxes on its share of the entity's taxable income as reduced by distributions to beneficiaries.

Example (1) – Trust T receives a Schedule K-1 from Partnership P reflecting taxable income of \$1 million. Partnership P distributes \$100,000 to T, which allocates the receipts to income. Both Trust T and income Beneficiary B are in the 35 percent tax bracket.

Trust T's tax on \$1 million of taxable income is \$350,000. Under Subsection (c) T's tax must be paid from income receipts because receipts from the entity are allocated only to income. Therefore, T must apply the entire \$100,000 of income receipts to pay its tax. In this case, Beneficiary B receives nothing.

Example (2) – Trust T receives a Schedule K-1 from Partnership P reflecting taxable income of \$1 million. Partnership P distributes \$500,000 to T, which allocates the receipts to income. Both Trust T and income Beneficiary B are in the 35 percent tax bracket.

Trust T's tax on \$1 million of taxable income is \$350,000. Under Subsection (c), T's tax must be paid from income receipts because receipts from P are allocated only to income. Therefore, T uses \$350,000 of the \$500,000 to pay its taxes and distributes the remaining \$150,000 to B. The \$150,000 payment to B reduces T's taxes by \$52,500, which it must pay to B. But the \$52,500 further reduces T's taxes by \$18,375, which it also must pay to B. In fact, each time T makes a distribution to B, its taxes are further reduced, causing another payment to be due B.

Alternatively, T can apply the following algebraic formula to determine the amount payable to B:

$$D = (C - R \times K) / (1 - R)$$

D = Distribution to income beneficiary
 C = Cash paid by the entity to the trust
 R = tax rate on income
 K = entity's K-1 taxable income

Applying the formula to Example (2) above, Trust T must pay \$230,769 to B so that after deducting the payment, T has exactly enough to pay its tax on the remaining taxable income from P.

Taxable Income per K-1	\$1,000,000
Payment to beneficiary	230,769
Trust Taxable Income	\$ 769,231
35 percent tax	269,231
Partnership Distribution	\$ 500,000
Fiduciary's Tax Liability	(269,231)
Payable to the Beneficiary	\$ 230,769

The "payment to beneficiary" is calculated as $(C - R \times K) / (1 - R) = (500,000 - 0.35 \times 1,000,000) / (1 - 0.35) = (500,000 - 350,000) / (1 - 0.35) = 150,000 / 0.65 = \$230,769$ (where C is the cash distributed by the entity, R is the trust ordinary tax rate (35%), and K is the entity's K-1 taxable income).

In addition, B will report \$230,769 on his or her own personal income tax return, paying taxes of \$80,769. Because Trust T withheld \$269,231 to pay its taxes and B paid \$80,769 taxes of its own, B bore the entire \$350,000 tax burden on the \$1 million of entity taxable income, including the \$500,000 that the entity retained that presumably increased the value of the trust's investment entity.

If a trustee determines that it is appropriate to so, it should consider exercising the discretion granted in RUIA section 506 [now 507] to adjust between income and principal. Alternatively, the trustee may exercise the power to adjust under RUIA section 104 [now 203] to the extent it is available and appropriate under the circumstances, including whether a future distribution from the entity that would be allocated to principal should be reallocated to income because the income beneficiary already bore the burden of taxes on the reinvested income. In exercising the power, the trust should consider the impact that future distributions will have on any current adjustments.

SECTION 507. ADJUSTMENT BETWEEN INCOME AND PRINCIPAL

BECAUSE OF TAXES.

(a) A fiduciary may make an adjustment between income and principal to offset the shifting of economic interests or tax benefits between current income beneficiaries and successor

beneficiaries which arises from:

(1) an election or decision the fiduciary makes regarding a tax matter, other than a decision to claim an income tax deduction to which subsection (b) applies;

(2) an income tax or other tax imposed on the fiduciary or a beneficiary as a result of a transaction involving the fiduciary or a distribution by the fiduciary; or

(3) ownership by the fiduciary of an interest in an entity a part of whose taxable income, whether or not distributed, is includable in the taxable income of the fiduciary or a beneficiary.

(b) If the amount of an estate tax marital or charitable 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 the fiduciary or a beneficiary are decreased, the fiduciary shall charge each beneficiary that benefits from the decrease in income tax to 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 the principal used to pay the increase would have qualified for a marital or charitable deduction but for the payment. The share of the reimbursement for each fiduciary or beneficiary whose income taxes are reduced must be the same as its share of the total decrease in income tax.

(c) A fiduciary that charges a beneficiary under subsection (b) may offset the charge by obtaining payment from the beneficiary, withholding an amount from future distributions to the beneficiary, or adopting another method or combination of methods.

Comment

Mandatory adjustments. The adjustments addressed by Section 507 are derived from the history of “equitable adjustments” largely associated with New York case law. For example, *Matter of Warms*, 140 N.Y.S.2d 169 (1955), involved estate administration expenses chargeable

to principal that are allowed as either estate tax deductions or income tax deductions. If the items are claimed as income tax deductions and benefit income, *Warms* requires income to reimburse principal for any increased estate taxes. The *Warms* adjustment has been codified in some states, including New York in EPTL §11-2.1(a).

Subsection (b), which requires reimbursement of principal from income, is derived from New York's EPTL §11-2.1(a). Unlike the New York statute, however, it limits the mandatory reimbursement to cases in which a marital or charitable 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 United States Tax Court held that a reimbursement required by the predecessor of EPTL §11-2.1(a) preserved for the estate the same charitable 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 typically 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 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 still receive the additional benefit of the difference in the benefit of the two deductions. 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 by \$20,000 and the net benefit to the income beneficiaries will be \$10,000.

Other adjustments. A second occasion for adjustment is a "trapping distribution" – a distribution of principal that carries out income for income tax purposes. *Matter of Holloway*, 68 Misc.2d 361, 327 N.Y.S.2d 865 (1972), held that a trust that made a trapping distribution must reimburse principal for the income taxes resulting from the distribution.

A third adjustment context arises when a trust's deductible expenses chargeable to principal reduce distributable net income and the taxable income of an income beneficiary, and the trust has taxable gains. Must income reimburse principal for the capital gains taxes that would have been saved if the expenses were used to reduce the gains? A Pennsylvania case, *Rice Estate*, 8 Pa. D&C2d 379 (1956), required an adjustment, but a New York case, *Matter of Dick*, 29 Misc.2d 648, 218 N.Y.S.2d 182 (1961), and a Massachusetts case, *New England Merchants Nat'l Bank v. Converse*, 373 Mass. 639, 369 N.E.2d 982 (1972), rejected an adjustment. A similar New York case, *Matter of Pross*, 90 Misc.2d 895, 396 N.Y.S.2d 309 (1978), required an adjustment from income to principal when a capital gain on a sale of real property resulted from a depreciation deduction that had benefitted the income beneficiary of the trust by reducing distributable net income.

Subsection (a) allows adjustments in cases like these, in the fiduciary's discretion (recognizing that local case law and statutory law, other than this Act, may require the exercise of that discretion under this Act).

Changes in the 2018 Act. Section 506(b) of the 1997 Act required that "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 2018 Act changes this, in Section 507(b), to "the fiduciary shall charge each beneficiary that benefits from the decrease in income tax to

reimburse the principal from which the increase in estate tax is paid” and adds subsection (c) to provide the fiduciary with options for accomplishing the “reimbursement” objective. One option in subsection (c) remains “obtaining payment from the beneficiary,” but the possibly more practical option of withholding amounts from future distributions is also included.

[ARTICLE] 6

DEATH OF INDIVIDUAL OR TERMINATION OF INCOME INTEREST

SECTION 601. DETERMINATION AND DISTRIBUTION OF NET INCOME.

(a) This section applies when:

- (1) the death of an individual results in the creation of an estate or trust; or
- (2) an income interest in a trust terminates, whether the trust continues or is

distributed.

(b) A fiduciary of an estate or trust with an income interest that terminates shall determine, under subsection [(g)][(e)] and [Articles] 4, 5, and 7, the amount of net income and net principal receipts received from property specifically given to a beneficiary. The fiduciary shall distribute the net income and net principal receipts to the beneficiary that is to receive the specific property.

(c) A fiduciary shall determine the income and net income of an estate or income interest in a trust which terminates, other than the amount of net income determined under subsection (b), under [Articles] 4, 5, and 7 and by:

- (1) including in net income all income from property used or sold to discharge liabilities;
- (2) paying from income or principal, in the fiduciary’s discretion, fees of attorneys, accountants, and fiduciaries, court costs and other expenses of administration, and interest on estate and inheritance taxes and other taxes imposed because of the decedent’s death, but the fiduciary may pay the expenses from income of property passing to a trust for which the

fiduciary claims a federal estate tax marital or charitable deduction only to the extent:

(A) the payment of the expenses from income will not cause the reduction or loss of the deduction; or

(B) the fiduciary makes an adjustment under Section 507(b); and

(3) paying from principal other disbursements made or incurred in connection with the settlement of the estate or the winding up of an income interest that terminates, including:

(A) to the extent authorized by the decedent's will, the terms of the trust, or applicable law, debts, funeral expenses, disposition of remains, family allowances, estate and inheritance taxes, and other taxes imposed because of the decedent's death; and

(B) related penalties that are apportioned, by the decedent's will, the terms of the trust, or applicable law, to the estate or income interest that terminates.

{(d) If a decedent's will, the terms of a trust, or applicable law provides for the payment of interest or the equivalent of interest to a beneficiary that receives a pecuniary amount outright, the fiduciary shall make the payment from net income determined under subsection (c) or from principal to the extent net income is insufficient.

(e) If a beneficiary is to receive a pecuniary amount outright from a trust after an income interest ends because of an income beneficiary's death, and no payment of interest or the equivalent of interest is provided for by the terms of the trust or applicable law, the fiduciary shall pay the interest or the equivalent of interest to which the beneficiary would be entitled under applicable law if the pecuniary amount were required to be paid under a will.}

{(f)}{(d)} A fiduciary shall distribute net income{ remaining after payments required by subsections (d) and (e)} in the manner described in Section 602 to all other beneficiaries,

including a beneficiary that receives a pecuniary amount in trust, even if the beneficiary holds an unqualified power to withdraw assets from the trust or other presently exercisable general power of appointment over the trust.

~~{(g)}~~~~{(e)}~~ A fiduciary may not reduce principal or income receipts from property described in subsection (b) because of a payment described in Section 501 or 502, to the extent the decedent's will, the terms of the trust, or applicable law requires the fiduciary to make the payment from assets other than the property or to the extent the fiduciary recovers or expects to recover the payment from a third party. The net income and principal receipts from the property must be determined by including the amount the fiduciary receives or pays regarding the property, whether the amount accrued or became due before, on, or after the date of the decedent's death or an income interest's terminating event, and making a reasonable provision for an amount the estate or income interest may become obligated to pay after the property is distributed.

Legislative Note: *If state law already provides for interest on payments from a trust on the death of an income beneficiary, delete or modify subsections (d) and (e). If subsections (d) and (e) are not deleted, use the subsection reference in the first set of brackets in subsections (b), (f), and (g). If subsections (d) and (e) are deleted, use the subsection reference in the second set of brackets in subsection (b) and redesignated subsections (d) and (e), and delete the words in brackets in redesignated subsection (d).*

Comment

Article 6 of the 2018 Act, Death of Decedent or Termination of Income Interest, is not greatly changed from Article 2 of the 1997 Act, Decedent's Estate or Terminating Income Interest. Paragraph (3) of Section 201 of the 1997 Act, addressing the payment of interest on pecuniary bequests or pecuniary amounts payable by a trust (explained below in the paragraph captioned "Interest on pecuniary amounts"), is divided into two optional subsections (d) and (e) of Section 601 in the 2018 Act. As explained in the Legislative Note, a state may use these subsections if it has no other provision for payment of interest on pecuniary amounts received from a trust. In that case, subsection (e) will provide that interest is payable on pecuniary amounts received from a trust in the same manner as state law otherwise provides in the case of pecuniary bequests under a will, and subsection (d) will provide that all such interest payments are made from income to the extent income is sufficient. If state law already provides for the payment of interest on pecuniary amounts received from a trust, subsections (d) and (e) may be

modified or omitted.

The Treasury Regulations contemplated by the Comment to the 1997 Act to respond to the Supreme Court's decision in *Commissioner v. Estate of Hubert*, 520 U.S. 93 (1997), were added in 1999 as Treasury Regs. §§20.2056(b)-4(d), 20.2055-3(b), and 20.2013-4(b)(3).

Comment to 1997 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) [now 601(d) through (f)] 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) [now 601(d) and (e)] 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) [now 601(c)(2)] 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) [now 601(c)(2)] 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 deduction, which means that the limit on the amount payable from income will be established eventually by Treasury Regulations.

SECTION 602. DISTRIBUTION TO SUCCESSOR BENEFICIARY.

(a) Except to the extent [Article] 3 applies for a beneficiary that is a trust, each beneficiary described in Section [601(f)][601(d)] is entitled to receive a share of the net income equal to the beneficiary's fractional interest in undistributed principal assets, using values as of the distribution date. If a fiduciary makes more than one distribution of assets to beneficiaries to which this section applies, each beneficiary, including a beneficiary that does not receive part of the distribution, is entitled, as of each distribution date, to a share of the net income the fiduciary received after the decedent's death, an income interest's other terminating event, or the preceding distribution by the fiduciary.

(b) In determining a beneficiary's share of net income under subsection (a), the following

rules apply:

(1) The beneficiary is entitled to receive a share of the net income equal to the beneficiary's fractional interest in the undistributed principal assets immediately before the distribution date.

(2) The beneficiary's fractional interest under paragraph (1) must be calculated:

(A) on the aggregate value of the assets as of the distribution date without reducing the value by any unpaid principal obligation; and

(B) without regard to:

(i) property specifically given to a beneficiary under the decedent's will or the terms of the trust; and

(ii) property required to pay pecuniary amounts not in trust.

(3) The distribution date under paragraph (1) 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 the assets are distributed.

(c) To the extent a fiduciary does not distribute under this section all the collected but undistributed net income to each beneficiary as of a distribution date, the fiduciary shall maintain records showing the interest of each beneficiary in the net income.

(d) If this section applies to income from an asset, a fiduciary may apply the rules in this section to net gain or loss realized from the disposition of the asset after the decedent's death, an income interest's terminating event, or the preceding distribution by the fiduciary.

Legislative Note: *If subsections (d) and (e) of Section 601 are deleted, use the subsection reference in the second set of brackets in subsection (a).*

Comment

Section 202(a) of the 1997 Act ended with a reference 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.” The 2018 Act changes this, in Section 602(a), to “a share of the net income the fiduciary received after the decedent’s death, an income interest’s other terminating event, or the preceding distribution by the fiduciary.” “The preceding distribution by the fiduciary” will prevent the possible misunderstanding that “earlier distribution date,” in context, refers to a distribution date earlier than “the date of death or terminating event.” So-called “stub income” between the last distribution date and the date of death is addressed in Section 703(b). The former words “but has not distributed as of the current distribution date” are not needed because Section 602(c) makes it clear that the fiduciary must account for all undistributed income.

Section 602(b)(2)(B) excludes specific bequests in kind and pecuniary bequests (and comparable distributions from a trust) from the calculation of a beneficiary’s fractional interest of undistributed principal assets for purposes of allocating income to that beneficiary. If the beneficiary is entitled to statutory interest on any such bequest, that interest is not income subject to allocation under this section, and that bequest does not share in the income earned by the other assets.

Section 602(a) includes an exception for the portion of an estate or trust that is treated as a unitrust under new Article 3.

Comment to 1997 Act

Relationship to prior Acts. Section 202 [now 602] 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.

[ARTICLE] 7

APPORTIONMENT AT BEGINNING AND END OF INCOME INTEREST

SECTION 701. WHEN RIGHT TO INCOME BEGINS AND ENDS.

(a) An income beneficiary is entitled to net income in accordance with the terms of the trust from the date an income interest begins. The 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:

- (1) the trust for the current income beneficiary; or
- (2) a successive interest for a successor beneficiary.

(b) An asset becomes subject to a trust under subsection (a)(1):

(1) for an asset that is transferred to the trust during the settlor's life, on the date the asset is transferred;

(2) for an asset that becomes subject to the trust because of a decedent's death, on the date of the decedent's death, even if there is an intervening period of administration of the decedent's estate; or

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

(c) An asset becomes subject to a successive interest under subsection (a)(2) 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 which a fiduciary may or must distribute income.

Comment

Article 7 of the 2018 Act, Apportionment at Beginning and End of Income Interest, corresponds to Article 3 of the 1997 Act, with the same title. There is no substantive change in Section 701 (previously Section 301).

Comment to 1997 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 [now 702 and 703] apply accordingly if the terms of the trust do not contain different provisions.

**SECTION 702. APPORTIONMENT OF RECEIPTS AND DISBURSEMENTS
WHEN DECEDENT DIES OR INCOME INTEREST BEGINS.**

(a) A fiduciary shall allocate an income receipt or disbursement, other than a receipt to which Section 601(b) applies, to principal if its due date occurs before the date on which:

- (1) for an estate, the decedent died; or
- (2) for a trust or successive interest, an income interest begins.

(b) If the due date of a periodic income receipt or disbursement occurs on or after the date on which a decedent died or an income interest begins, a fiduciary shall allocate the receipt or disbursement to income.

(c) If an income receipt or disbursement is not periodic or has no due date, a fiduciary shall treat the receipt or disbursement under this section as accruing from day to day. The fiduciary shall allocate to principal the portion of the receipt or disbursement accruing before the date on which a decedent died or an income interest begins, and to income the balance.

(d) A receipt or disbursement is periodic under subsections (b) and (c) if:

- (1) the receipt or disbursement must be paid at regular intervals under an obligation to make payments; or
- (2) the payor customarily makes payments at regular intervals.

(e) An item of income or obligation is due under this section on the date the payor is required to make a payment. If a payment date is not stated, there is no due date.

(f) Distributions to shareholders or other owners from an entity to which Section 401 applies are due:

- (1) on the date fixed by or on behalf of the entity for determining the persons entitled to receive the distribution;

(2) if no date is fixed, on the date of the decision by or on behalf of the entity to make the distribution; or

(3) if no date is fixed and the fiduciary does not know the date of the decision by or on behalf of the entity to make the distribution, on the date the fiduciary learns of the decision.

Comment

In Section 702(a) of the 2018 Act, the change from “before a decedent dies” and “before an income interest begins” in Section 302(a) of the 1997 Act to “before the date on which ... the decedent died” and “before the date on which ... an income interest begins” makes this provision consistent with the reference to “the date of a testator’s death” in Section 701(b)(2) and consistent with the reference to “on or after the date on which a decedent died” in Section 702(b). It means that the time of day at which the moment of death occurs is less relevant and therefore less important to determine. In effect, the decedent’s income interest ends with the day before the date of death, and the estate’s income interest begins with the date of death. This rule in a uniform act does not purport to address related income tax uncertainties.

Section 302(b) of the 1997 Act used the term “periodic due date.” Section 702(b) of the 2018 Act changes the use of “periodic” to modify receipts or disbursements rather than due dates. Section 702(d) explains when a receipt or disbursement is “periodic.”

With respect to distributions from an entity, Section 302(c) of the 1997 Act uses the term “declaration date for the distribution,” consistent with the action of a board of directors in a corporate context. In the 2018 Act, Section 702(f)(2) uses the more generic description “date of the decision by or on behalf of the entity to make the distribution.” The 2018 Act adds Section 702(f)(3) to authorize the fiduciary to use the date the fiduciary learns of the decision if the fiduciary doesn’t know the date the decision was made. If a date is fixed by or on behalf of the entity for determining who is to receive a distribution, that date continues to govern, under Section 702(f)(1).

SECTION 703. APPORTIONMENT WHEN INCOME INTEREST ENDS.

(a) In this section, “undistributed income” means net income received on or before the date on which an income interest ends. The term does not include an item of income or expense which 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 otherwise provided in subsection (c), when a mandatory income interest of a beneficiary ends, the fiduciary shall pay the beneficiary’s share of the undistributed income

that is not disposed of under the terms of the trust to the beneficiary or, if the beneficiary does not survive the date the interest ends, to the beneficiary's estate.

(c) If a beneficiary has an unqualified power to withdraw more than five percent of the value of a trust immediately before an income interest ends:

(1) the fiduciary shall allocate to principal the undistributed income from the portion of the trust which may be withdrawn; and

(2) subsection (b) applies only to the balance of the undistributed income.

(d) When a fiduciary's obligation to pay a fixed annuity or a fixed fraction of the value of assets ends, the fiduciary shall prorate the final payment as required to preserve an income tax, gift tax, estate tax, or other tax benefit.

Comment

In Section 703(a) of the 2018 Act, a change from "before the date on which an income interest ends" in Section 303(a) of the 1997 Act to "on or before the date on which an income interest ends" makes this provision consistent with the corresponding references in Sections 701 and 702 (former Sections 301 and 302). Applying the rules of Section 701, that means that income received precisely on the date of a decedent's death is allocated to the estate, estate beneficiaries, or successive beneficiaries of a trust, not to the decedent. As with Section 702, this rule in a uniform act does not purport to address related income tax uncertainties.

There are no other substantive changes from the 1997 Act in Section 703. In subsection (c), a beneficiary's right to "revoke" is changed to the right to "withdraw." In subsection (d), the subjective "accomplish a purpose of the trust or its settlor relating to income, gift, estate, or other tax requirements" is changed to the more objective "preserve an income tax, gift tax, estate tax, or other tax benefit."

In Section 703(b), it remains the general rule that the income accrued between the last payment date and the date of a mandatory income beneficiary's death (often called "stub income") is payable to that income beneficiary's estate. As with other provisions of this act, under Section 201(a)(3) the terms of the trust may provide a different disposition of stub income.

[ARTICLE] 8

MISCELLANEOUS PROVISIONS

SECTION 801. 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 802. RELATION TO ELECTRONIC SIGNATURES IN GLOBAL AND NATIONAL COMMERCE ACT . This act modifies, limits, or supersedes the Electronic Signatures in Global and National Commerce Act, 15 U.S.C. Section 7001 et seq., but does not modify, limit, or supersede Section 101(c) of that act, 15 U.S.C. Section 7001(c), or authorize electronic delivery of any of the notices described in Section 103(b) of that act, 15 U.S.C. Section 7003(b).

SECTION 803. APPLICATION TO TRUST OR ESTATE. This act applies to a trust or estate existing or created on or after [the effective date of this act], except as otherwise expressly provided in the terms of the trust or this act.

{**SECTION 804. SEVERABILITY.** 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.}

Legislative Note: Include this section only if the state lacks a general severability statute or a decision by the highest court of the state stating a general rule of severability.

SECTION 805. REPEALS; CONFORMING AMENDMENTS.

~~(a)~~

~~(b)~~

~~(c)~~

K.S.A. 58a-103 is hereby amended to read as follows: 58a-103. As used in this code:

- (1) "Action," with respect to an act of a trustee, includes a failure to act.
- (2) "Beneficiary" means a person that:
 - (A) Has a present or future beneficial interest in a trust, vested or contingent; or
 - (B) in a capacity other than that of trustee, holds a power of appointment over trust property.
- (3) "Charitable trust" means a trust, or portion of a trust, created for a charitable purpose described in subsection (a) of K.S.A. 58a-405, and amendments thereto.
- (4) "Conservator" means a person appointed by the court pursuant to K.S.A. 59-3001 et seq., and amendments thereto, to administer the estate of a minor or adult individual.
- (5) "Environmental law" means a federal, state, or local law, rule, regulation, or ordinance relating to protection of the environment.
- (6) "Guardian" means a person appointed by the court pursuant to K.S.A. 59-3001 et seq., and amendments thereto, to make decisions regarding the support, care, education, health, and welfare of a minor or adult individual. The term does not include a guardian ad litem.
- (7) "Interests of the beneficiaries" means the beneficial interests provided in the terms of the trust.
- (8) "Jurisdiction," with respect to a geographic area, includes a state or country.

(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.

(10) "Power of withdrawal" means a presently exercisable general power of appointment other than a power:

(A) Exercisable by a trustee and limited by an ascertainable standard relating to an individuals health, education, support or maintenance within the meaning of section 2041(b)(1)(A) or 2514(c)(1) of the Internal Revenue Code of 1986, as in effect on July 1, 2006; or

(B) exercisable by another person only upon consent of the trustee or a person holding an adverse interest.

(11) "Property" means anything that may be the subject of ownership, whether real or personal, legal or equitable, or any interest therein.

(12) (A) "Qualified beneficiary" means a beneficiary who, as of the date in question, either is eligible to receive mandatory or discretionary distributions of trust income or principal, or would be so eligible if the trust terminated on that date.

(B) For the purpose of trustee determining "qualified beneficiaries" of a trust in which a beneficial interest is subject to a power of appointment of any nature, the trustee may conclusively presume such power of appointment has not been exercised unless the trustee has been furnished by the powerholder or the legal representative of the powerholder or the powerholder's estate with the original or a copy of an instrument validly exercising such power of appointment, in which event the qualified beneficiaries shall be subsequently determined by giving due consideration to such exercise unless and until the trustee has been given notification in a similar manner of an instrument which validly revokes or modifies such exercise.

(13) "Revocable," as applied to a trust, means revocable by the settlor without the consent of the trustee or a person holding an adverse interest.

(14) "Settlor" means a person, including a testator, who creates, or contributes property to, a trust. If more than one person creates or contributes property to a trust, each person is a settlor of the portion of the trust property attributable to that person's contribution except to the extent another person has the power to revoke or withdraw that portion.

(15) "Spendthrift provision" means a term of a trust which restrains either voluntary or involuntary transfer of a beneficiary's interest.

(16) "State" means a state of the United States, the District of Columbia, Puerto Rico, the United States Virgin Islands, or any territory or insular possession subject to the jurisdiction of the United States. The term includes an Indian tribe or band recognized by federal law or formally acknowledged by a state.

(17) "Terms of a trust" means:

(a) except as otherwise provided in subparagraph (b), the manifestation of the settlor's intent regarding a trust's provisions as: (1) expressed in the trust instrument; or (2) as may be established by other evidence that would be admissible in a judicial proceeding; or

(b) the trust's provisions as established, determined, or amended by: (1) a trustee or person holding a power to direct under K.S.A. 58a-808, and amendments thereto, in accordance with applicable law; (2) court order; or (3) a nonjudicial settlement agreement under K.S.A. 58a-111, and amendments thereto.

(18) "Trust instrument" means an instrument executed by the settlor that contains terms of the trust, including any amendments thereto.

(19) "Trustee" includes an original, additional, and successor trustee, and a cotrustee.

K.S.A. 58-9-101, 58-9-102, 58-9-103, 58-9-104, 58-9-105, 58-9-106, 58-9-201, 58-9-202, 58-9-301, 58-9-302, 58-9-303, 58-9-401, 58-9-402, 58-9-403, 58-9-404, 58-9-405, 58-9-406, 58-9-407, 58-9-408, 58-9-409, 58-9-410, 58-9-411, 58-9-412, 58-9-413, 58-9-414, 58-9-415, 58-9-501, 58-9-502, 58-9-503, 58-9-504, 58-9-505, 58-9-506, 58-9-601, 58-9-602, 58-9-603, and 58-9-606 are hereby repealed.

Legislative Note: *A state that has enacted a previous version of the Uniform Principal and Income Act or another statute addressing principal and income should consider repealing that statute or amending that statute to make it effective only before the effective date of this act. A state that has enacted a separate statute permitting conversion of trusts to unitrusts or otherwise addressing unitrusts as in Article 3 of this act, or has enacted other statutes addressing the issues addressed by this act, should consider repealing those statutes or amending those statutes to*

make them effective only before the effective date of this act.

SECTION 806. EFFECTIVE DATE. This {act} ~~takes~~ shall take effect . . . and be in
force from and after its publication in the statute book.