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# the uniform principal and income act

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*MSK Client Alert*

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The Uniform Law Commissioners approved a revised Uniform Principal and Income Act in the Summer of 1997, and the Act is currently in different stages of the adoption process in various states. It has now been adopted in Arkansas, California, Connecticut, Iowa, North Dakota, Oklahoma, Virginia and West Virginia.<sup>1</sup> Since the principal and income act of each state contains the trust accounting rules to determine the net income of a trust, the spreading adoption of the new Uniform Act is especially important for administration of trusts making distributions based on income, including net-income unitrusts. In many states in which the Act has been adopted, the new rules apply to trusts already in existence.

## **Net-Income Unitrusts**

A charitable remainder unitrust with a net-income limitation has historically been among the most popular tools used by charitable gift planners, if not indeed the most popular. While this popularity has to a certain extent been overtaken since the issuance by the Internal Revenue Service in December, 1998, of final regulations under Internal Revenue Code section 664 by the "flip" unitrust -- a trust which begins its life as a net-income unitrust and at some later date drops the income limitation to become a standard unitrust -- it is important to remember that even flip unitrusts have a net-income limitation for at least a portion of their term. There is every reason to believe that charitable remainder unitrusts with net-income limitations will continue to enjoy widespread use by planners, since the net-income limitation -- whether in a flip unitrust or in a unitrust that will retain its net-income limitation during its entire term -- typically serves an important planning objective. Without it, the trustee of a unitrust funded with an illiquid asset is faced with the pressure of having to sell the asset, or otherwise obtain liquidity in the trust, in order to make required distributions. The limitation allows distributions to be limited to the lesser of a fixed percentage of the value of trust assets, determined annually (the unitrust amount) or the net income of the trust. If the trust lacks income, the trustee will not be forced to take actions possibly detrimental to the trust beneficiary in order to make a scheduled distribution of the unitrust amount.<sup>2</sup>

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transactional tax



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It is critically important to the trustee -- and to those planning and drafting these trusts -- to understand what is the net income of the trust for this purpose. Income for this purpose is not taxable income, used elsewhere in the Internal Revenue Code to calculate the income subject to tax, nor is it financial accounting income, determined under generally accepted accounting principles and used by businesses to state their financial condition in a uniform format. Instead, Code section 643(b) provides that income for this purpose is determined under the terms of the governing instrument (here the agreement or declaration establishing the trust) and applicable local law. In most states, the source of that "local law" is the principal and income act in effect in that state.

### **The Uniform Principal and Income Act**

In general terms, a principal and income act is a set of accounting rules to be used by trustees and other fiduciaries, such as estate executors, in allocating receipts and expenditures of the estate or trust between the entity's principal and income accounts. This accounting determines the amount distributable to an income beneficiary when the right of that beneficiary to receive distributions is based on the income of the estate or trust. Apportionment of a receipt to the income account will increase the amount distributable to the income beneficiary, but if it is apportioned to the principal account it will not. Conversely, apportionment of an expense item to the income account will reduce distributions to the income beneficiary, while apportionment of that item to the principal account will not.<sup>3</sup>

The principal and income laws of most states characterize these rules as defaults which will apply unless, and to the extent, they are not overridden in the governing instrument. This feature allows the draftsman the unique ability to write rules into a will or trust to determine fiduciary accounting income in a manner most suitable to that entity and the requirements of its beneficiaries.<sup>4</sup>

The Uniform Principal and Income Act is one of a large number of uniform laws proposed by the Uniform Law Commission in an effort to make the laws of the various states more consistent. Two prior versions of the Uniform Principal and Income Act had been proposed by the Commission in 1931 and 1962, which were adopted in forty-one states. The 1997 version updates and significantly revises the 1962 Act.

### **Trustee Reallocation Power**

The most important change made by the new Act is the power granted to trustees to "... adjust between principal and income to the extent the trustee considers necessary if the trustee invests and manages trust assets as a prudent investor..."<sup>5</sup> The purpose of this provision is to allow trustees to invest for a total return, a portion of which may come from capital appreciation of trust assets rather than traditional income items such as interest and dividends. This provision is a significant departure from the 1962 version of the Uniform Act, since for the first time a fiduciary is allowed to allocate trust principal to the income beneficiary (or to reallocate a portion of the trust income to principal), even if no provision exists in the trust document allowing the fiduciary to do so. What this means in practice is that a trustee could allocate to the income of a net-income unitrust all or a portion of a realized capital gain, even though capital gains are allocated to principal under the normal rules, if the trustee determines that the allocation is necessary to balance the interests of the beneficiaries in the trust.



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This provision of the Act grew out of the Uniform Management of Institutional Funds Act which in 1972 first introduced the concept of investing for total return, rather than simply to generate current income, in the case of institutional endowments, and the Uniform Prudent Investor Act in 1995 which applies modern portfolio theory to private trusts. Taken together, this progression of uniform legislation recognizes the importance to all beneficiaries -- income and remainder -- of the trustee investing for total return, and at the same time that the traditional concepts of "principal" and "income" may not accommodate total return investing in a way that will be fair to all beneficiaries.

However, the power to reallocate is not unlimited. The Act requires that three conditions must be met before the trustee can exercise the power to adjust. The first condition is that the trustee must invest and manage trust assets as a prudent investor. This requirement will be met if the trust is governed by the law of a state in which the Uniform Prudent Investor Act has been enacted, the prudent investor rule has been adopted by the courts or the terms of the trust require it.

The second condition is that the trust document by its terms bases distributions on "income". This requirement is met not only by trusts that require distribution of all income, but also by trusts which allow the trustee discretion to distribute part or all of the income while adding to principal any undistributed income. This condition is also met by a charitable remainder unitrust with a net-income limitation, since distributions are limited to the lesser of trust income or the unitrust amount.

The third condition which must be met for the trustee to be able to exercise the power to reallocate underscores the importance of balancing the interests of all trust beneficiaries. The trustee must first determine from the trust document whether the trustor intended to favor the income or remainder beneficiary in the investment and administration of trust assets. To the extent the document does not require or permit partiality in favor of either class of beneficiary, the trustee must administer the trust impartially, based on what is fair to all beneficiaries.<sup>6</sup> In the case of a charitable remainder trust, which typically does not require or permit partiality by the trustee in favoring either the income or remainder beneficiaries of the trust, the trustee must determine that the necessary impartiality cannot be achieved by application of the "default" principal and income characterizations, without exercise of the power to reallocate receipts and disbursements between principal and income.

The Act lists situations in which the trustee is prohibited or restricted from exercising the power. A significant limitation, which in some situations can constitute a trap for the unwary, prohibits the trustee from exercising the reallocation power if the trustee is a beneficiary of the trust. This limitation will not only prevent reallocation where the trustee is the grantor and income beneficiary of the trust (and there are thousands of these trusts in existence), but also where the trustee is the charity which is the remainder beneficiary of the trust. In other words, unless a power to reallocate is specifically written into the trust -- uncommon in existing CRTs -- the Act empowers only independent trustees to exercise the power. To achieve the benefits and flexibility afforded by the reallocation power, it may be necessary to appoint a special trustee to exercise the power or to modify provisions of the trust document concerning the removal and replacement of trustees. Drafters of new net-income unitrusts can avoid this problem by writing the reallocation power into the accounting provisions of the trust instrument, and making it clear that the power may be exercised by a trustee even if the trustee is also a beneficiary of the trust.<sup>7</sup>



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The Internal Revenue Service is not unaware of the power given by the Uniform Act and its predecessors to drafters to deviate from the default rules for determining trust income, and has put us on notice that not all such deviations will be respected. The Treasury Regulations provide:

*"Trust provisions which depart fundamentally from concepts of local law in the determination of what constitutes income are not recognized for this purpose. For example, if a trust instrument directs that all trust income shall be paid to A, but defines ordinary dividends and interest as corpus, the trust will not be considered one which under its governing instrument is required to distribute all its income..."<sup>8</sup>*

The basic concept underlying the power to reallocate is that exercise of the power will at times be necessary to impartially balance the interests of the income and remainder beneficiary. Granting the power to a beneficiary-trustee, through a special provision in the trust document, should not be a fundamental departure from this concept, since any fiduciary -- whether or not that fiduciary is also a beneficiary -- will be under the same duty. The Service should therefore have no basis under this provision of the Regulations to disregard the grant in a trust instrument of the power to reallocate, or the exercise of that power with respect specific items of trust receipts or expenditures.<sup>9</sup>

Of course, a beneficiary-trustee always has an inevitable conflict of interest, between its duty of impartiality as trustee in administering the trust and its own self-interest in maximizing the value of the remainder or income interest in the trust. The Act does nothing to alleviate this conflict, nor does a provision in the trust document granting a beneficiary-trustee the power to reallocate. Indeed, since exercise of this power directly affects how much each class of beneficiaries will receive, potential liability of a beneficiary-trustee to other classes of beneficiaries is actually increased by including this power to reallocate in the trust instrument. Thus, a beneficiary-trustee will not only be subject to the usual second-guessing by other beneficiaries concerning investment decisions, but also concerning trust accounting decisions if the trustee is given the power to reallocate receipts and disbursements.

The importance for net-income unitrusts of the power to allocate between income and principal is illustrated by a situation in which the only receipts for the year are from the realization of capital gains. If the only device available to the trustee is an "on-off switch" in the trust instrument, which says that all capital gains shall be allocated to income, the portion of the realized gain characterized as income may be more than would be needed to balance the interests of the income and remainder beneficiaries of the trust. In fact, the interest of the remainder beneficiary has clearly suffered, since the principal of the trust is not protected against inflation. With the power to allocate, preferably in the document but at least now supplied (to an independent trustee) by statute, the realized capital gain may be apportioned between income and principal, to provide adequately for the income beneficiary while allowing growth of principal to protect both the income and remainder beneficiaries from future erosion of purchasing power.

### **Underproductive Property Rule**

The 1962 Act gave an income beneficiary the right to receive a portion from the proceeds of sale of property that did not produce adequate income during the time it was held by the trust. This so-called underproductive property rule required the trustee to determine what was a reasonable amount of income to have earned from



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comparable trust property during the period the property in question was held by the trust. To the extent the trust realized a gain from the sale of that asset, the trustee was required by the rule to recharacterize as income a portion of the gain otherwise allocable to trust principal. The underproductive property has been used by trustees of net-income unitrusts to allocate a portion of realized capital gains to income, even without a specific provision in the trust document allowing the trustee to do so.

The revised Act, by providing the broad power to reallocate trust receipts and disbursements between income and principal, has made the underproductive property rule unnecessary, and repeals it for trusts other than marital deduction trusts.<sup>10</sup>

### **Mutual Fund Distributions**

In addition to the giving trustees unprecedented power to reallocate trust receipts and disbursements between income and principal in a manner different from the "default" fiduciary accounting rules that would otherwise apply, the revised Uniform Principal and Income Act provides far more detailed default rules than its predecessors, with specific rules for a broader range of items.

The Act distinguishes between different types of distributions from mutual funds. The general rule is that distributions from any type of entity, including a mutual fund, are income.<sup>11</sup> Excluded from this general rule are long-term capital gain distributions, which are principal. But mutual funds often distribute both long-term and short-term capital gains, and short-term capital gains dividends remain subject to the general rule -- they are allocated to income. This is an important change from the previous uniform act, under which all capital gain distributions are principal.

This treatment of mutual fund distributions is important, since use of these investment vehicles by CRT trustees has grown as a means to achieve asset diversification and lower-cost professional asset management. To put the change in context, two additional points should be made. First, it is not uncommon for trustees to elect to reinvest mutual fund dividends in additional shares of the mutual fund. Under the Act, the shares purchased through dividend reinvestment are principal, not income, whether they are ordinary or capital gain dividends. Thus, in many cases, whether a mutual fund capital gain distribution is long or short term will have little practical significance. Second, the trustee remains subject to the fiduciary duty to balance the interests of income and remainder beneficiaries of the trust. To the extent that too large a portion of mutual fund distributions receipts would be allocated to income, due to the treatment of short-term capital gains, or too little, due to the reinvestment of those distributions, the trustee still may, and indeed under the Act must, exercise the power to allocate described above to balance the interests of the beneficiaries.

### **Zero Coupon Bonds**

Unlike regular bonds which are issued at face value and pay interest periodically to holders, zero coupon bonds pay no interest at all -- they are issued at a discount from face value and the holder realizes the equivalent of interest in the form of accrued bond discount when the bond is sold or matures and is redeemed for the full face value. Since the accrued bond discount is the investor's equivalent of interest, it is treated as interest for income tax purposes. This leads some planners to assume that accrued bond discount, when realized by the trust, is



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treated also as income for fiduciary accounting purposes. However, the default treatment under the Act is exactly the opposite -- realized bond discount is treated as principal.<sup>12</sup>

Zero coupons bonds have been a popular income timing device for NIMCRUTs, with which deferred income can be accrued a predictable rate for future distribution when the bonds are sold or redeemed. To give the trustee the flexibility to pursue this investment strategy, it has always been advisable for the drafter to include a specific provision in the trust document's accounting rules allocating realized bond discount to income. This is even more the case now that the Act provides a contrary default result.

### Receipts from Entities

The Act provides detailed default rules for fiduciary accounting characterization of receipts from entities. For this purpose, an entity includes a corporation, partnership, limited liability company, mutual fund, real estate investment trust (REIT) and common trust fund. The general rule is simple enough: except as otherwise provided, money received from an entity is allocated to income.<sup>13</sup> One shouldn't discount the usefulness of this simple general rule, since the result under the 1962 uniform act was ambiguous. However the devil, as they say, is in the details -- or in this case, the "otherwise provided."

To place the discussion in context, consider a net-income unitrust holding an interest in a partnership. Assume that the partnership conducts a variety of investment activities, generating interest, dividends, short-term capital gains and long term capital gain. For tax accounting purposes, the partnership is merely a conduit, with tax characteristics of its income flowing through to its partners, whether or not that income is distributed.<sup>14</sup> If a charitable remainder trust is a partner, the income of the partnership -- whether distributed or not -- fills up the appropriate tier under the four-tier system for characterizing CRT distributions, with ordinary income flowing into tier 1, capital gain into tier 2 and tax-exempt income into tier 3.<sup>15</sup> For fiduciary accounting purposes, two issues are whether a trust is deemed to receive partnership income that is not distributed and how distributions should be apportioned between income and principal of the trust. The Act disposes of the first issue by making it clear that there is no partnership conduit principle for fiduciary accounting purposes: the trust will account for partnership income only when a distribution is received.

When it comes to characterizing distributions from the partnership for fiduciary accounting principles, the general rule that all distributions are income would appear to function consistently with distribution provisions of a net income unitrust with a make-up provision. During years in which the partnership makes no distributions, the unitrust will have no fiduciary accounting income and will therefore make no distributions to the income beneficiary, and the trustee will keep track of a deficiency account -- the cumulative amount by which the unitrust amount has exceeded the income of the trust. If in a subsequent year the partnership makes a distribution to the unitrust, it will be characterized as fiduciary accounting income under the general rule. The trustee will therefore distribute the entire amount received from the partnership, to the extent of the deficiency account plus the unitrust amount for the current year. Even though the tax characteristics of the distribution have been determined in previous years, through the combination of the conduit principle for partnership tax accounting and the four-tier system for characterizing CRT distributions, the requirement to make distributions from a net-income unitrust with make-up provision has effectively been deferred through the trust's investment in the partnership.<sup>16</sup>



The Act, however, contains important exceptions to this general rule. First, a partnership distribution of property other than money is allocated to principal under the default rule.<sup>17</sup> This provision could create planning opportunities or another trap for the unwary. Assume, for example, a NIMCRUT with a deficiency account of 100 holds an interest in a partnership about to distribute to the trust property with a value of 100. If the partnership distributes cash, the distribution will be treated as income by the trustee who will distribute it to the income beneficiary. On the other hand, if the partnership instead distributes property other than cash -- even publicly-traded securities -- the distribution is characterized as principal and no distribution is made to the income beneficiary.<sup>18</sup>

Another important exception to the general rule that amounts received from entities is allocated to income is that money received from an entity in partial liquidation of the entity is allocated to principal.<sup>19</sup> How does a trustee know if the distribution is in partial liquidation of the entity? One way is if the entity informs the trustee that this is the case.<sup>20</sup> However, amounts received from an entity will be treated as being in partial liquidation if the total amount of money and other property received in a distribution or a series of related distributions is greater than twenty percent of the entity's gross assets, as shown on the entity's financial statements. But for purposes of this twenty percent test, the portion of the distribution that does not exceed the amount of income tax that the trustee or beneficiary must pay on the entity's taxable income is ignored. To illustrate, consider our example of an interest in a partnership held by a NIMCRUT with a deficit account of 100 in a year in which the partnership makes a distribution of 100. If the gross assets of the partnership is 400, the distribution could be deemed to be in partial liquidation and therefore allocable to principal of the trust. If, however, the income beneficiary will pay income tax on the distribution of 30,<sup>21</sup> this portion of the distribution may be ignored when applying the twenty percent test. Since the remaining portion -- 70 -- is less than twenty percent of the value gross value of partnership assets -- 400 -- the distribution is not treated as a partial distribution and will be characterized under the Act as income, distributable by the NIMCRUT trustee to the extent of the deficiency account.<sup>22</sup>

### The Importance of Trust Language

The revised Act, like its predecessor, provides a set of default rules to guide the trustee in the absence of specific provisions in the trust instrument. The primary themes of the Act include both increasing and focusing of these default rules.<sup>23</sup> Since the Act now covers a broader array of categories of trust receipts and disbursements, it is more important than ever for the drafter of net-income unitrusts to place the desired accounting rules into the text of the document, at least to the extent that the desired result is different from the Act's default rules. The drafter may be lulled into reliance on the power granted to trustees by the Act to allocate receipts between principal and income, but must remember that the Act extends this power only to trustees which are not also beneficiaries of the trust. In the world of CRTs, where it is very common for the income or remainder beneficiary to also serve as trustee, the flexibility arising from this provision of the Act may prove illusory. But like the default rules for characterizing receipts and disbursements, this restriction may also be overridden by a specific provision in the trust instrument authorizing the trustee to allocate between principal and income in the manner provided in the Act, even if the trustee is also a beneficiary of the trust. Such a provision should be seriously considered for all new net-income and flip unitrusts.



**Endnotes:**

1. As of April 15, 2000, the Uniform Act had been introduced for adoption in Alabama, Colorado, the District of Columbia, Hawaii, Illinois, Kansas, Kentucky, Maryland, Michigan, Minnesota, Mississippi, Nebraska and Vermont. Readers may check the web site of the Commissioners, [www.law.upenn.edu/bll/ulc/ulcframe.htm](http://www.law.upenn.edu/bll/ulc/ulcframe.htm), to determine whether the Act has been introduced for adoption in other states.
2. One means of obtaining liquidity in the trust is for the trustee to borrow against the illiquid assets held in the trust. Regulations proposed by the IRS under Code section 643(a)(7) on October 19, 1999 treat the trust as having sold trust assets to the extent the distribution would otherwise be treated as a tax free return of corpus (tier 4 of the 4-tier system for characterizing CRT distributions for tax purposes), effectively recharacterizing the distribution as either tier 1 ordinary income or tier 2 long-term capital gain.
3. Note that these rules do not impact amounts distributable to a beneficiary from a trust not dependent on trust income, including charitable remainder unitrusts without a net-income limitation and charitable remainder annuity trusts.
4. As noted below, the Internal Revenue Service is not unaware of this ability to essentially write one's own accounting rules. See text accompanying note 8.
5. Uniform Principal and Income Act (1997) (the "Act") §104.
6. Act §103(b).
7. Act §103(a)(1) directs the trustee to administer the trust in accordance with its terms, even if there is a different provision in the act. Thus, even though the Act prohibits a beneficiary-trustee from exercising the power to reallocate, this power may be granted in the trust document.
8. Treasury Regulations §1.643(b)-1.
9. The IRS might, however, take the position that exercise of the power in a given situation could be an act of self-dealing under Code section 4941(d)(1)(E) as a "use" by a disqualified person of trust assets. Since a charity is not a disqualified person for purposes of the self-dealing rules (Treas. Reg. §53.4946-1(a)(8)), this assertion could only be made concerning an income beneficiary serving as trustee of a charitable remainder trust, and would presumably be overcome by a showing that the trustee acted fairly in balancing the interests of the income and remainder beneficiaries when exercising the power to reallocate.
10. Act §413.
11. Act §401.
12. Act §406(b)
13. Act §401(b)



14. IRC §701 - 702.
15. IRC §664(b)
16. The IRS is again not unaware of these mechanics, and has expressed on more than one occasion its consternation that planners might take advantage of them in order to time distributions from a NIMCRUT. See, e.g., Shoemaker and Jones, "Charitable Remainder Trusts: The Income Deferral Abuse and Other Issues", IRS exempt Organizations CPE Textbook 1997-139, and Revenue Procedure 97-23, 1997-1 C.B. 654.
17. Act §401(c)(1)
18. Of course the trustee may be able to exercise the power to reallocate the distribution partly or completely to income, if the trustee is not a trust beneficiary (under section 104 of the Act, discussed above) or if the trust document grants this power to the trustee.
19. Act §401(c)(3)
20. Act §401(d)(1)
21. As noted above, the tax undistributed income of the partnership in prior years has filled up CRT tiers under the conduit principle of partnership taxation. But CRT distributions are strictly characterized for tax purposes under the four-tier system. The mismatch between fiduciary and tax accounting rules creates confusion when reducing the distribution by income tax arising from it when applying this twenty percent test. For example, assume that the only income earned by the partnership has been long-term capital gain of 100 that has flowed into tier 2 of the NIMCRUT in the years it was earned by not distributed. This year, the NIMCRUT receives ordinary income of 100 from other sources, which flows into tier 1, as well as the partnership distribution. To determine the amount of reduction for taxes in applying the twenty percent rule, does the trustee reduce the distribution by actual taxes payable by the beneficiary -- tax at ordinary income rates on the tier 1 distribution -- or tax that would have been payable only on the partnership income -- tax at the long-term capital gain rate? This is another instance in which guidance to the trustee by the draftsman could prove useful.
22. Another ambiguity in this provision of the Act is whether the twenty percent test should apply to all distributions or only the distribution made to the trust in question. For example, if in our illustration the trust is just one of three equal partners, each of which receives a distribution from the partnership of 100, the distribution should probably be viewed as a partial distribution under Act section 401(d), since total distributions of 300 are made from a partnership with assets of only 400, even though literal application of the language of the Act provision does not yield this result. Again, the message to the draftsman is that the trustee of a net income unitrust will be well-served by specific language in the trust document that covers the accounting treatment of distributions from entities.
23. For the sake of brevity, this discussion has focused on only a few of these rules. The Act contains default rules for a wide range of trust receipts, from those arising from minerals and timber to asset-backed securities. For further detail, readers are directed not only to the Act itself, but also to the very informative comments prepared by the Uniform Law Commissioners on, which appears on the web site cited in Note 1.



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