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**PROPOSED PENNSYLVANIA  
UNIFORM PRINCIPAL AND INCOME ACT**

**AND OTHER PROPOSED AMENDMENTS**

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**REPORT OF THE  
ADVISORY COMMITTEE ON  
DECEDENTS' ESTATES LAWS**



General Assembly of the Commonwealth of Pennsylvania  
JOINT STATE GOVERNMENT COMMISSION  
108 Finance Building  
Harrisburg, Pennsylvania 17120  
June 2001

The release of this report should not be interpreted as an endorsement by the members of the Executive Committee of the Joint State Government Commission of all the findings, recommendations and conclusions contained in this report.

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The Joint State Government Commission was created by the act of July 1, 1937 (P.L.2460, No.459) as amended, as a continuing agency for the development of facts and recommendations on all phases of government for the use of the General Assembly.

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June 2001

TO THE MEMBERS OF THE GENERAL ASSEMBLY:

The Joint State Government Commission is pleased to present the report of the Advisory Committee on Decedents' Estates Laws. This report includes a recommended revised Uniform Principal and Income Act and other proposed amendments with official comments. For over 55 years, the members of the advisory committee have worked to ensure that our probate laws are among the most modern and efficient in the nation.

Respectfully submitted,

A handwritten signature in black ink that reads "Roger A. Madigan".

Roger A. Madigan  
Chair







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## INTRODUCTION

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This is the fourteenth report of the Joint State Government Commission Advisory Committee on Decedents' Estates Laws since the June 30, 1972 codification of the Probate, Estates and Fiduciaries Code as Title 20 of the Pennsylvania Consolidated Statutes. At its June 4, 2001 meeting, the task force authorized the introduction of legislation recommended by the advisory committee. The legislation includes a revised Uniform Principal and Income Act and other proposed amendments to Title 20. The legislation and the official comments of the advisory committee are set forth on the following pages. The official comments may be used in determining the intent of the General Assembly. See 1 Pa.C.S. § 1939 and *In re Martin's Estate*, 365 Pa. 280, 74 A.2d 120 (1950).



## **SUMMARY OF RECOMMENDATIONS**

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The proposed legislation contains the following recommendations:

- Enact the Pennsylvania Uniform Principal and Income Act as Chapter 81 of Title 20
- Permit a trustee to convert a trust to a unitrust (§ 8105)
- Incorporate the concept of the principal place of the trust's administration as the primary basis for determining the situs of the trust (§ 724)
- Provide a rule of succession in the case of an intestacy occurring at the termination of a valid prior estate (§ 2104(11))
- Clarify certain rules regarding the apportionment of Federal estate tax (§§ 3701, 3702(f) and (j))
- Permit certain custodianships under the Pennsylvania Uniform Transfers to Minors Act to continue until not later than the time the minor attains the age of 25 years where the transfer is made pursuant to a provision in a will, trust or life insurance beneficiary designation (§§ 5320 and 5321)
- Clarify that section 6205 (effect of disclaimer) is not intended to diminish the interest of any person other than the disclaimant in the disclaimed property which such person acquired in his or her own right (§ 6205(a))
- Provide that nothing in section 6205 (effect of disclaimer) shall determine the effect of a disclaimer upon the rights of creditors of the disclaimant (§ 6205(d))
- Establish a framework for trustee resignations (§§ 7104 and 7105)



# PRINCIPAL AND INCOME ACT

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## CHAPTER 81

### PRINCIPAL AND INCOME

#### Subchapter

- A. Preliminary Provisions; Power to Adjust; Power to Convert to Unitrust
- B. Decedent's Estate or Terminating Income Interest
- C. Apportionment at Beginning and End of Income Interest
- D. Allocation of Receipts During Administration of Trust
- E. Allocation of Disbursements During Administration of Trust
- F. and G. (Reserved)
- H. Miscellaneous Provisions

#### SUBCHAPTER A

##### PRELIMINARY PROVISIONS; POWER TO ADJUST; POWER TO CONVERT TO UNITRUST

**Note: In each Uniform Act comment, the parallel Pennsylvania citation is provided in parentheses and italicized.**

Sec.

8101. Scope

8102. Definitions.

- 8103. Fiduciary duties; general principles.
  - 8104. Trustee's power to adjust.
  - 8105. Power to convert to unitrust.
  - 8106. Judicial control of discretionary powers.
  - 8107. (Reserved).
  - 8108. (Reserved).
  - 8109. (Reserved).
  - 8110. (Reserved).
  - 8111. (Reserved).
  - 8112. (Reserved).
  - 8113. Charitable trusts.
- § 8101. Scope.

This chapter shall be known and may be cited as the "Pennsylvania Uniform Principal and Income Act."

**Source Note: Section 101 of the Uniform Act.**

**Pennsylvania Comment: Section 8101. This chapter is based on the 1997 Uniform Principal and Income Act promulgated by the National Conference of Commissioners on Uniform State Laws with some changes. Those changes are explained in the Pennsylvania comments.**

§ 8102. Definitions.

The following words and phrases when used in this chapter shall have the meanings given to them in this section unless the context clearly indicates otherwise:



“Accounting period.” A calendar year, unless another 12-month period is selected by a fiduciary. The term includes a portion of a calendar year or other 12-month period which begins when an income interest begins or ends when an income interest ends.

“Beneficiary.” Includes:

- (1) in the case of a decedent’s estate, any heir, legatee and devisee; and
- (2) in the case of a trust, an income beneficiary and a remainder beneficiary.

“Fiduciary.” A personal representative or a trustee.

“Income.” Money or property which a fiduciary receives as current return from a principal asset. The term includes a portion of receipts from a sale, exchange or liquidation of a principal asset, to the extent provided in Subchapter D (relating to allocation of receipts during administration of trust).

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

“Income interest.” The right of an income beneficiary to receive all or part of net income, whether the governing instrument requires it to be distributed or authorizes it to be distributed in the trustee’s discretion.

“Mandatory income interest.” The right of an income beneficiary to receive net income which the governing instrument requires the fiduciary to distribute.

“Net income.” The:

- (1) total receipts allocated to income during an accounting period; minus

(2) disbursements made from income during the period; plus or minus

(3) transfers under this chapter to or from income during the period.

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

“Principal.” Property held in trust for distribution to a remainder beneficiary when the trust terminates.

“Remainder beneficiary.” A person entitled to receive principal when an income interest ends.

“Sui juris beneficiary.” Includes:

(1) a court-appointed guardian of an incapacitated beneficiary;

(2) an agent for an incompetent beneficiary; and

(3) a court-appointed guardian of a minor beneficiary’s estate or, if none, the parents of the minor beneficiary.

“Trust.” Includes a legal life estate arrangement.

“Trustee.” Includes an original, additional or successor trustee, whether or not appointed or confirmed by a court.

**Source Note: Section 102 of the Uniform Act.**

**Uniform Act Comment: “Income beneficiary.” The definitions of income beneficiary (section 102(5)) (section 8102) and income interest (section 102(6)) (section 8102) cover both mandatory and discretionary beneficiaries and interests. There are no definitions for “discretionary income beneficiary”**

or “discretionary income interest” because those terms are not used in the Act.

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

*“Net income.”* The reference to “transfers under this Act to or from income” means transfers made under sections 104(a) (8104(a)), 412(b) (8152(b)), 502(b) (8162(b)), 503(b) (8164(a)), 504(a) (8165(a)), and 506 (8167).

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

Pennsylvania Comment: Section 8102. The phrase “governing instrument” is substituted for the words “terms of the trust or will” in the Uniform Act, because “governing instrument” is the phrase used throughout 20 Pa.C.S. (PEFCODE), and it does not seem desirable to expand the admissibility of extrinsic evidence.

Under common law principles, an agent acting under a power of attorney for a principal who is a competent beneficiary could act for the beneficiary. Thus the term “sui juris beneficiaries” includes such an agent.

§ 8103. Fiduciary duties; general principles.

(a) Allocation.--In allocating receipts and disbursements to or between principal and income and with respect to any matter within the scope of this chapter, the following shall apply:

(1) A fiduciary shall administer a trust or estate in accordance with the governing instrument, even if there is a different provision in this chapter.

(2) A fiduciary may administer a trust or estate by the exercise of a discretionary power of administration regarding a matter within the scope of this chapter given to the fiduciary by the governing instrument, even if the exercise of the power produces a result different from a result required or permitted by this chapter. No inference that the fiduciary has improperly exercised the discretionary power shall arise from that fact that the fiduciary has made an allocation contrary to a provision of this chapter.

(3) A fiduciary shall administer a trust or estate in accordance with this chapter if the governing instrument does not contain a different provision or does not give the fiduciary a discretionary power of administration regarding a matter within the scope of this chapter.

(4) A fiduciary shall add a receipt or charge a disbursement to principal to the extent that the governing instrument and this chapter do not provide a rule for allocating the receipt or disbursement to or between principal and income.

(b) Discretionary power.--In exercising a discretionary power of administration regarding a matter within the scope of this chapter, whether granted by the governing instrument or this chapter, including section 8104

(relating to trustee's power to adjust) and section 8105 (relating to power to convert to unitrust), a fiduciary shall administer a trust or estate impartially based on what is fair and reasonable to all of the beneficiaries, except to the extent that the governing instrument clearly manifests an intention that the fiduciary shall or may favor one or more of the beneficiaries. A determination in accordance with this chapter is presumed to be fair and reasonable to all of the beneficiaries.

**Source Note: Section 103 of the Uniform Act.**

**Uniform Act Comment: *Prior act.* The rule in section 2(a) of the 1962 Act is restated in section 103(a) (8103(a)), without changing its substance, to emphasize that the Act contains only default rules and that provisions in the terms of the trust are paramount. However, section 2(a) of the 1962 Act applies only to the allocation of receipts and disbursements to or between principal and income. In this Act, the first sentence of section 103(a) (8103(a)) states that it also applies to matters within the scope of Articles 2 and 3. Section 103(a)(2) (8103(a)(2)) incorporates the rule in section 2(b) of the 1962 Act that a discretionary allocation made by the trustee that is contrary to a rule in the Act should not give rise to an inference of imprudence or partiality by the trustee.**

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

***Fiduciary discretion.* The general rule is that if a discretionary power is conferred upon a trustee, the exercise of that power is not subject to control by a court except to prevent an abuse of**

discretion. Restatement (Second) of Trusts § 187. The situations in which a court will control the exercise of a trustee's discretion are discussed in the comments to § 187. See also *id.* § 233, Comment *p*.

*Questions for which there is no provision.* Section 103(a)(4) (8103(a)(4)) allocates receipts and disbursements to principal when there is no provision for a different allocation in the terms of the trust, the will, or the Act. This may occur because money is received from a financial instrument not available at the present time (inflation-indexed bonds might have fallen into this category had they been announced after this Act was approved by the Commissioners on Uniform State Laws) or because a transaction is of a type or occurs in a manner not anticipated by the Drafting Committee for this Act or the drafter of the trust instrument.

Allocating to principal a disbursement for which there is no provision in the Act or the terms of the trust preserves the income beneficiary's level of income in the year it is allocated to principal, but thereafter will reduce the amount of income produced by the principal. Allocating to principal a receipt for which there is no provision will increase the income received by the income beneficiary in subsequent years, and will eventually, upon termination of the trust, also favor the remainder beneficiary. Allocating these items to principal implements the rule that requires a trustee to administer the trust impartially, based on what is fair and reasonable to both income and remainder beneficiaries. However, if the trustee decides that an adjustment between principal and income is needed to enable the trustee to comply with section 103(b) (8103(b)), after considering the return from the portfolio as a whole, the trustee may make an appropriate adjustment under section 104(a) (8104(a)).

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

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

**The terms of a trust may provide that the trustee, or an accountant engaged by the trustee, or a committee of persons who may be family members or business associates, shall have the power to determine what is income and what is principal. If the terms of a trust provide that this Act specifically or principal and income legislation in general does not apply to the trust but fail to provide a rule to deal with a matter provided for in this Act, the trustee has an implied grant of discretion to decide the question. Section 103(b) (8103(b)) provides that the rule of impartiality applies in the exercise of such a discretionary power to the extent that the terms of the trust do not provide that one or more of the beneficiaries are to be favored. The fact that a person is named an income beneficiary or a remainder beneficiary is not by itself an indication of partiality for that beneficiary.**

**Pennsylvania Comment: Section 8103. The additional words at the end of section 8103(a)(2) are taken from the California version of the Uniform Act. Calif. Probate Code § 16335(a)(2).**

**Section 8103(b) contains an impartiality standard. This does not require that the trustee treat the income beneficiary and the remainder beneficiary equally, because most creators of trusts intend the trustee to favor those generationally closest to them.**

§ 8104. Trustee’s power to adjust.

(a) Adjustment.--Subject to subsections (c) and (f), a trustee may adjust between principal and income by allocating an amount of income to principal or an amount of principal to income to the extent the trustee considers appropriate if:

- (1) the governing instrument describes what may or must be distributed to a beneficiary by referring to the trust’s income; and

(2) the trustee determines, after applying the rules in section 8103(a) (relating to fiduciary duties; general principles), that the trustee is unable to comply with section 8103(b).

(b) Considerations.--In deciding whether and to what extent to exercise the power conferred by subsection (a), a trustee may consider, among other things, all of the following:

- (1) The size of the trust.
- (2) The nature and estimated duration of the trust.
- (3) The liquidity and distribution requirements of the trust.
- (4) The needs for regular distributions and preservation and appreciation of capital.
- (5) The expected tax consequences of an adjustment.
- (6) The net amount allocated to income under the other sections of this chapter and the increase or decrease in the value of the principal assets, which the trustee may estimate as to assets for which market values are not readily available.
- (7) The assets held in the trust; the extent to which they consist of financial assets, interests in closely held enterprises, tangible and intangible personal property or real property; the extent to which an asset is used by a beneficiary; and whether an asset was purchased by the trustee or received from the settlor or testator.



(8) To the extent reasonably known to the trustee, the needs of the beneficiaries for present and future distributions authorized or required by the governing instrument.

(9) Whether and to what extent the governing instrument gives the trustee the power to invade principal or accumulate income or prohibits the trustee from invading principal or accumulating income, and the extent to which the trustee has exercised a power from time to time to invade principal or accumulate income.

(10) The intent of the settlor or testator.

(11) The actual and anticipated effect of economic conditions on principal and income and effects of inflation and deflation.

(c) Prohibited adjustments.--A trustee may not make an adjustment under this section if any of the following apply:

(1) The adjustment would diminish the income interest in a trust which requires all of the income to be paid at least annually to a spouse and for which a Federal estate tax or gift tax marital deduction would be allowed, in whole or in part, if the trustee did not have the power to make the adjustment.

(2) The adjustment would reduce the actuarial value of the income interest in a trust to which a person transfers property with the intent to qualify for a Federal gift tax exclusion.

(3) The adjustment would change the amount payable to a beneficiary as a fixed annuity or a fixed fraction of the value of the trust assets.

(4) The adjustment is from any amount which is permanently set aside for charitable purposes under the governing instrument and for which a Federal estate or gift tax deduction has been taken unless both income and principal are so set aside.

(5) If:

(i) possessing or exercising the power to make an adjustment would cause an individual to be treated as the owner of all or part of the trust for Federal income tax purposes; and

(ii) the individual would not be treated as the owner if the trustee did not possess the power to make an adjustment.

(6) If:

(i) possessing or exercising the power to make an adjustment would cause all or part of the trust assets to be subject to Federal estate or gift tax with respect to an individual; and

(ii) the assets would not be subject to Federal estate or gift tax with respect to the individual if the trustee did not possess the power to make an adjustment.

(7) If the trustee is a beneficiary of the trust.

(8) If the trust has been converted under section 8105 (relating to power to convert to unitrust).

(d) Permissible adjustment when otherwise prohibited.--If subsection (c)(5),

(6) or (7) applies to a trustee and there is more than one trustee, a cotrustee to

whom the provision does not apply may make the adjustment unless the exercise of the power by the remaining trustee or trustees is prohibited by the governing instrument.

(e) Release of the power to adjust.--

(1) If paragraph (2) applies, a trustee may release any of the following:

(i) The entire power conferred by subsection (a).

(ii) The power to adjust from income to principal.

(iii) The power to adjust from principal to income.

(2) A release under paragraph (1) is permissible if any of the following apply:

(i) The trustee is uncertain about whether possessing or exercising the power will cause a result described in subsection (c)(1) through (6).

(ii) The trustee determines that possessing or exercising the power will or may deprive the trust of a tax benefit or impose a tax burden not described in subsection (c).

(3) The release may be permanent or for a specified period, including a period measured by the life of an individual.

(f) Application.--A governing instrument which limits the power of a trustee to make an adjustment between principal and income does not affect the application of this section unless it is clear from the governing instrument that it is intended to deny the trustee the power of adjustment conferred by subsection (a).

**Source Note: Section 104 of the Uniform Act.**

**Uniform Act Comment: *Purpose and scope of provision.*** The purpose of section 104 (8104) is to enable a trustee to select investments using the standards of a prudent investor without having to realize a particular portion of the portfolio's total return in the form of traditional trust accounting income such as interest, dividends, and rents. Section 104(a) (8104(a)) authorizes a trustee to make adjustments between principal and income if three conditions are met: (1) the trustee must be managing the trust assets under the prudent investor rule; (2) the terms of the trust must express the income beneficiary's distribution rights in terms of the right to receive "income" in the sense of traditional trust accounting income; and (3) the trustee must determine, after applying the rules in section 103(a) (8103(a)), that he is unable to comply with section 103(b) (8103(b)). In deciding whether and to what extent to exercise the power to adjust, the trustee is required to consider the factors described in section 104(b) (8104(b)), but the trustee may not make an adjustment in circumstances described in section 104(c) (8104(c)).

Section 104 (8104) does not empower a trustee to increase or decrease the degree of beneficial enjoyment to which a beneficiary is entitled under the terms of the trust; rather, it authorizes the trustee to make adjustments between principal and income that may be necessary if the income component of a portfolio's total return is too small or too large because of investment decisions made by the trustee under the prudent investor rule. The paramount consideration in applying section 104(a) (8104(a)) is the requirement in section 103(b) (8103(b)) that "a fiduciary must administer a trust or estate impartially, based on what is fair and reasonable to all of the beneficiaries, except to the extent that the terms of the trust or the will clearly manifest an intention that the fiduciary shall or may favor one or more of the beneficiaries." The power to adjust is subject to control by the court to prevent an abuse of discretion. Restatement (Second) of Trusts § 187 (1959). See also id. §§ 183, 232, 233, Comment *p* (1959).

Section 104 (8104) will be important for trusts that are irrevocable when a State adopts the prudent investor rule by statute or judicial approval of the rule in Restatement of Trusts 3d: Prudent Investor Rule. Wills and trust instruments executed after the rule is adopted can be drafted to describe a beneficiary's distribution rights in terms that do not depend

upon the amount of trust accounting income, but to the extent that drafters of trust documents continue to describe an income beneficiary's distribution rights by referring to trust accounting income, section 104 (8104) will be an important tool in trust administration.

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

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

To meet the third condition, the trustee must first meet the requirements of section 103(a) (8103(a)), i.e., she must apply

the terms of the trust, decide whether to exercise the discretionary powers given to the trustee under the terms of the trust, and must apply the provisions of the Act if the terms of the trust do not contain a different provision or give the trustee discretion. Second, the trustee must determine the extent to which the terms of the trust clearly manifest an intention by the settlor that the trustee may or must favor one or more of the beneficiaries. To the extent that the terms of the trust do not require partiality, the trustee must conclude that she is unable to comply with the duty to administer the trust impartially. To the extent that the terms of the trust do require or permit the trustee to favor the income beneficiary or the remainder beneficiary, the trustee must conclude that she is unable to achieve the degree of partiality required or permitted. If the trustee comes to either conclusion - that she is unable to administer the trust impartially or that she is unable to achieve the degree of partiality required or permitted - she may exercise the power to adjust under section 104(a) (8104(a)).

*Impartiality and productivity of income.* The duty of impartiality between income and remainder beneficiaries is linked to the trustee's duty to make the portfolio productive of trust accounting income whenever the distribution requirements are expressed in terms of distributing the trust's "income." The 1962 Act implies that the duty to produce income applies on an asset by asset basis because the right of an income beneficiary to receive "delayed income" from the sale proceeds of underproductive property under section 12 of that Act arises if "any part of principal ... has not produced an average net income of a least 1% per year of its inventory value for more than a year ... ." Under the prudent investor rule, "[t]o whatever extent a requirement of income productivity exists, ... the requirement applies not investment by investment but to the portfolio as a whole." Restatement of Trusts 3d: Prudent Investor Rule § 227, Comment *i*, at 34. The power to adjust under section 104(a) (8104(a)) is also to be exercised by considering net income from the portfolio as a whole and not investment by investment. Section 413(b) (8153(b)) of this Act eliminates the underproductive property rule in all cases other than trusts for which a marital deduction is allowed; the rule applies to a marital deduction trust if the trust's assets "consist substantially of property that does not provide the spouse with sufficient income from or use of the

trust assets ...” in other words, the section applies by reference to the portfolio as a whole.

While the purpose of the power to adjust in section 104(a) (8104(a)) is to eliminate the need for a trustee who operates under the prudent investor rule to be concerned about the income component of the portfolio’s total return, the trustee must still determine the extent to which a distribution must be made to an income beneficiary and the adequacy of the portfolio’s liquidity as a whole to make that distribution.

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

*Factors to consider in exercising the power to adjust.* Section 104(b) (8104(b)) requires a trustee to consider factors relevant to the trust and its beneficiaries in deciding whether and to what extent the power to adjust should be exercised. Section 2(c) of the Uniform Prudent Investor Act sets forth circumstances that a trustee is to consider in investing and managing trust assets. The circumstances in section 2(c) of the Uniform Prudent Investor Act are the source of the factors in paragraphs (3) through (6) and (8) of section 104(b) (8104(b)) (modified where necessary to adapt them to the purposes of this Act) so that, to the extent possible, comparable factors will apply to investment decisions and decisions involving the power to adjust. If a trustee who is operating under the prudent investor rule decides that the portfolio should be composed of financial assets whose total return will result primarily from capital appreciation rather than dividends, interest, and rents, the trustee can decide at the same time the extent to which an adjustment from principal to income may be necessary under section 104 (8104). On the other hand, if a trustee decides that the risk and return objectives for the trust are best achieved by a portfolio whose total return includes interest and dividend income that is sufficient to provide the income beneficiary with the beneficial interest to which the beneficiary is entitled under the terms of the trust, the trustee can decide that it is unnecessary to exercise the power to adjust.

*Assets received from the settlor.* Section 3 of the Uniform Prudent Investor Act provides that “[a] trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying.” The special circumstances may include the wish to retain a family business, the benefit derived from deferring liquidation of the asset in order to defer payment of income taxes, or the anticipated capital appreciation from retaining an asset such as undeveloped real estate for a long period. To the extent the trustee retains assets received from the settlor because of special circumstances that overcome the duty to diversify, the trustee may take these circumstances into account in determining whether and to what extent the power to adjust should be exercised to change the results produced by other provisions of this Act that apply to the retained assets. See section 104(b)(5) (8104(b)(5)); Uniform Prudent Investor Act § 3, Comment, 7B U.L.A. 18, at 25-26 (Supp. 1997); Restatement of Trusts 3d: Prudent Investor Rule § 229 and Comments *a-e*.

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

Under subsection (c)(1), a trustee cannot make an adjustment that diminishes the income interest in a trust that requires all of the income to be paid at least annually to a spouse and for which an estate tax or gift tax marital deduction is allowed; but this subsection does not prevent the trustee from making an adjustment that increases the amount of income paid from a marital deduction trust to the spouse. Subsection (c)(1) applies to a trust that qualifies for the marital deduction because the spouse has a general power of appointment over the trust, but it applies to a qualified terminable interest property (QTIP) trust only if and to the extent that the fiduciary makes the election required to obtain the tax deduction. Subsection (c)(1) does not apply to a so-called “estate” trust. This type of trust qualifies for the marital deduction because the terms of the trust require the principal and undistributed income to be paid



to the surviving spouse's estate when the spouse dies; it is not necessary for the terms of an estate trust to require the income to be distributed annually. Reg. § 20.2056(c)-2(b)(1)(iii).

Subsection (c)(3) applies to annuity trusts and unitrusts with no charitable beneficiaries as well as to trusts with charitable income or remainder beneficiaries; its purpose is to make it clear that a beneficiary's right to receive a fixed annuity or a fixed fraction of the value of a trust's assets is not subject to adjustment under section 104(a) (8014(a)). Subsection (c)(3) does not apply to any additional amount to which the beneficiary may be entitled that is expressed in terms of a right to receive income from the trust. For example, if a beneficiary is to receive a fixed annuity or the trust's income, whichever is greater, subsection (c)(3) does not prevent a trustee from making an adjustment under section 104(a) (8104(a)) in determining the amount of the trust's income.

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

*Release of the power to adjust.* Section 104(e) (8104(e)) permits a trustee 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 tax benefit or impose a tax burden. For example, if possessing the power would diminish the actuarial value of the income interest in a trust for which the income beneficiary's estate may be eligible to claim a credit for property previously taxed if the beneficiary dies within ten years after the death of the person creating the trust, the trustee is permitted under subsection (e) to release just the power to adjust from income to principal.

*Trust terms that limit a power to adjust.* Section 104(f) (8104(f)) applies to trust provisions that limit a trustee's power to adjust. Since the power is intended to enable trustees to employ the prudent investor rule without being constrained by traditional principal and income rules, an instrument executed before the adoption of this Act whose terms describe the amount that may or must be distributed to a beneficiary by referring to the trust's income or that prohibit the invasion of

principal or that prohibit equitable adjustments in general should not be construed as forbidding the use of the power to adjust under section 104(a) (8104(a)) if the need for adjustment arises because the trustee is operating under the prudent investor rule. Instruments containing such provisions that are executed after the adoption of this Act should specifically refer to the power to adjust if the settlor intends to forbid its use. See generally, Joel C. Dobris, Limits on the Doctrine of Equitable Adjustment in Sophisticated Postmortem Tax Planning, 66 Iowa L. Rev. 273 (1981).

*Examples.* The following examples illustrate the application of section 104 (8104):

*Example (1)* -- T is the successor trustee of a trust that provides income to A for life, remainder to B. T has received from the prior trustee a portfolio of financial assets invested 20% in stocks and 80% in bonds. Following the prudent investor rule, T determines that a strategy of investing the portfolio 50% in stocks and 50% in bonds has risk and return objectives that are reasonably suited to the trust, but T also determines that adopting this approach will cause the trust to receive a smaller amount of dividend and interest income. After considering the factors in section 104(b) (8104(b)), T may transfer cash from principal to income to the extent T considers it necessary to increase the amount distributed to the income beneficiary.

*Example (2)* -- T is the trustee of a trust that requires the income to be paid to the settlor's son C for life, remainder to C's daughter D. In a period of very high inflation, T purchases bonds that pay double-digit interest and determines that a portion of the interest, which is allocated to income under section 406 (8146) of this Act, is a return of capital. In consideration of the loss of value of principal due to inflation and other factors that T considers relevant, T may transfer part of the interest to principal.

*Example (3)* -- T is the trustee of a trust that requires the income to be paid to the settlor's sister E for life, remainder to charity F. E is a retired schoolteacher who is single and has no children. E's income from her social security, pension, and savings exceeds the amount required to provide for her accustomed standard of living. The terms of the trust permit T to invade principal to provide for E's health and to support her

in her accustomed manner of living, but do not otherwise indicate that T should favor E or F. Applying the prudent investor rule, T determines that the trust assets should be invested entirely in growth stocks that produce very little dividend income. Even though it is not necessary to invade principal to maintain E's accustomed standard of living, she is entitled to receive from the trust the degree of beneficial enjoyment normally accorded a person who is the sole income beneficiary of a trust, and T may transfer cash from principal to income to provide her with that degree of enjoyment.

*Example (4)* -- T is the trustee of a trust that is governed by the law of State X. The trust became irrevocable before State X adopted the prudent investor rule. The terms of the trust require all of the income to be paid to G for life, remainder to H, and also give T the power to invade principal for the benefit of G for "dire emergencies only." The terms of the trust limit the aggregate amount that T can distribute to G from principal during G's life to 6% of the trust's value at its inception. The trust's portfolio is invested initially 50% in stocks and 50% in bonds, but after State X adopts the prudent investor rule T determines that, to achieve suitable risk and return objectives for the trust, the assets should be invested 90% in stocks and 10% in bonds. This change increases the total return from the portfolio and decreases the dividend and interest income. Thereafter, even though G does not experience a dire emergency, T may exercise the power to adjust under section 104(a) (8104(a)) to the extent that T determines that the adjustment is from only the capital appreciation resulting from the change in the portfolio's asset allocation. If T is unable to determine the extent to which capital appreciation resulted from the change in asset allocation or is unable to maintain adequate records to determine the extent to which principal distributions to G for dire emergencies do not exceed the 6% limitation, T may not exercise the power to adjust. See Joel C. Dobris, Limits on the Doctrine of Equitable Adjustment in Sophisticated Postmortem Tax Planning, 66 Iowa L. Rev. 273 (1981).

*Example (5)* -- T is the trustee of a trust for the settlor's child. The trust owns a diversified portfolio of marketable financial assets with a value of \$600,000, and is also the sole beneficiary of the settlor's IRA, which holds a diversified portfolio of marketable financial assets with a value of \$900,000. The trust

receives a distribution from the IRA that is the minimum amount required to be distributed under the Internal Revenue Code, and T allocates 10% of the distribution to income under section 409(c) (8149(d)) of this Act. The total return on the IRA's assets exceeds the amount distributed to the trust, and the value of the IRA at the end of the year is more than its value at the beginning of the year. Relevant factors that T may consider in determining whether to exercise the power to adjust and the extent to which an adjustment should be made to comply with section 103(b) (8103(b)) include the total return from all of the trust's assets, those owned directly as well as its interest in the IRA, the extent to which the trust will be subject to income tax on the portion of the IRA distribution that is allocated to principal, and the extent to which the income beneficiary will be subject to income tax on the amount that T distributes to the income beneficiary.

*Example (6)* -- T is the trustee of a trust whose portfolio includes a large parcel of undeveloped real estate. T pays real property taxes on the undeveloped parcel from income each year pursuant to section 501(3) (8161). After considering the return from the trust's portfolio as a whole and other relevant factors described in section 104(b) (8104(b)), T may exercise the power to adjust under section 104(a) (8104(a)) to transfer cash from principal to income in order to distribute to the income beneficiary an amount that T considers necessary to comply with section 103(b) (8103(b)).

*Example (7)* -- T is the trustee of a trust whose portfolio includes an interest in a mutual fund that is sponsored by T. As the manager of the mutual fund, T charges the fund a management fee that reduces the amount available to distribute to the trust by \$2,000. If the fee had been paid directly by the trust, one-half of the fee would have been paid from income under section 501(1) (8161) and the other one-half would have been paid from principal under section 502(a)(1) (8162). After considering the total return from the portfolio as a whole and other relevant factors described in section 104(b) (8104(b)), T may exercise its power to adjust under section 104(a) (8104(a)) by transferring \$1,000, or half of the trust's proportionate share of the fee, from principal to income.

**Pennsylvania Comment:** Section 8104. Paragraphing has been changed for clarity.

**Section 8104(a) deletes the requirement in the Uniform Act that in order to adjust, the trustee must follow the prudent investor rule. Such a requirement runs the risk of inadvertently negating the power to adjust.**

**Section 8104(b) follows to the extent possible the version and the ordering of this list in Pennsylvania's Prudent Investor Act.**

**The prohibition under section 8104(c)(1) does not extend to a trust which the fiduciary could but does not qualify as a QTIP, because in that situation no marital deduction would be allowed.**

**Regarding section 8104(c)(6), the language of the Uniform Act has been expanded to allow for additional situations in which an estate tax problem might arise.**

**Regarding section 8104(c)(8), the language in the Uniform Act prohibiting adjustments if the trustee is not a beneficiary but would be directly or indirectly benefited by the adjustment has been deleted, because it might prohibit a corporate trustee from, say, making an adjustment from income to principal and thereby increasing its future fees. Section 8104(c)(7) seems like sufficient protection from conflicts of interest.**

§ 8105. Power to convert to unitrust.

(a) Conversion.--Unless expressly prohibited by the governing instrument, a trustee may release the power under section 8104 (relating to trustee's power to adjust) and convert a trust into a unitrust as described in this section if all of the following apply:

(1) The trustee determines that the conversion will enable the trustee to better carry out the intent of the settlor or testator and the purposes of the trust.

(2) The trustee gives written notice of the trustee's intention to release the power to adjust and to convert the trust into a unitrust and of how the unitrust

will operate, including what initial decisions the trustee will make under this section, to all the sui juris beneficiaries who:

(i) are currently eligible to receive income from the trust; and

(ii) would receive, if no powers of appointment were exercised, a distribution of principal if the trust were to terminate immediately prior to the giving of notice.

(3) There is at least one sui juris beneficiary under paragraph (2)(i) and at least one sui juris beneficiary under paragraph (2)(ii).

(4) No sui juris beneficiary objects to the conversion to a unitrust in a writing delivered to the trustee within 60 days of the mailing of the notice under paragraph (2).

(b) Judicially approved conversion.--

(1) The trustee may petition the court to approve the conversion to a unitrust if any of the following apply:

(i) A beneficiary timely objects to the conversion to a unitrust.

(ii) There are no sui juris beneficiaries under subsection (a)(2)(i).

(iii) There are no sui juris beneficiaries under subsection (a)(2)(ii).

(2) A beneficiary may request a trustee to convert to a unitrust. If the trustee does not convert, the beneficiary may petition the court to order the conversion.

(3) The court shall approve the conversion or direct the requested conversion if the court concludes that the conversion will enable the trustee to better carry out the intent of the settlor or testator and the purposes of the trust.

(c) Consideration.--In deciding whether to exercise the power conferred by subsection (a), a trustee may consider, among other things, all of the following:

- (1) The size of the trust.
- (2) The nature and estimated duration of the trust.
- (3) The liquidity and distribution requirements of the trust.
- (4) The needs for regular distributions and preservation and appreciation of capital.
- (5) The expected tax consequences of the conversion.
- (6) The assets held in the trust; the extent to which they consist of financial assets, interests in closely held enterprises, tangible and intangible personal property or real property; and the extent to which an asset is used by a beneficiary.
- (7) To the extent reasonably known to the trustee, the needs of the beneficiaries for present and future distributions authorized or required by the governing instrument.
- (8) Whether and to what extent the governing instrument gives the trustee the power to invade principal or accumulate income or prohibits the trustee from invading principal or accumulating income and the extent to which the

trustee has exercised a power from time to time to invade principal or accumulate income.

(9) The actual and anticipated effect of economic conditions on principal and income and effects of inflation and deflation.

(d) Post conversion.--After a trust is converted to a unitrust, all of the following apply:

(1) The trustee shall follow an investment policy seeking a total return for the investments held by the trust, whether the return is to be derived:

- (i) from appreciation of capital;
- (ii) from earnings and distributions from capital; or
- (iii) from both.

(2) The trustee shall make regular distributions in accordance with the governing instrument construed in accordance with the provisions of this section.

(3) The term "income" in the governing instrument shall mean an annual distribution (the unitrust distribution) equal to 4% (the payout percentage) of the net fair market value of the trust's assets, whether such assets would be considered income or principal under other provisions of this chapter, averaged over the lesser of :

- (i) the three preceding years; or
- (ii) the period during which the trust has been in existence.



(e) Discretion of trustee.--The trustee may in the trustee's discretion from time to time determine all of the following:

- (1) The effective date of a conversion to a unitrust.
- (2) The provisions for prorating a unitrust distribution for a short year in which a beneficiary's right to payments commences or ceases.
- (3) The frequency of unitrust distributions during the year.
- (4) The effect of other payments from or contributions to the trust on the trust's valuation.
- (5) Whether to value the trust's assets annually or more frequently.
- (6) What valuation dates to use.
- (7) How frequently to value nonliquid assets and whether to estimate their value.
- (8) Whether to omit from the calculations trust property occupied or possessed by a beneficiary.
- (9) Any other matters necessary for the proper functioning of the unitrust.

(f) Allocation.--

(1) Expenses which would be deducted from income if the trust were not a unitrust may not be deducted from the unitrust distribution.

(2) Unless otherwise provided by the governing instrument, the unitrust distribution shall be paid from net income, as such term would be determined if the trust were not a unitrust. To the extent net income is insufficient, the unitrust distribution shall be paid from net realized short-term capital gains.

To the extent income and net realized short-term capital gains are insufficient, the unitrust distribution shall be paid from net realized long-term capital gains. To the extent income and net realized short-term and long-term capital gains are insufficient, the unitrust distribution shall be paid from the principal of the trust.

(g) Court orders.--The trustee or, if the trustee declines to do so, a beneficiary may petition the court to:

(1) Select a payout percentage different than 4%.

(2) Provide for a distribution of net income, as would be determined if the trust were not a unitrust, in excess of the unitrust distribution if such distribution is necessary to preserve a tax benefit.

(3) Average the valuation of the trust's net assets over a period other than three years.

(4) Reconvert from a unitrust. Upon a reconversion, the power to adjust under section 8104 shall be revived.

(h) Application.--A conversion to a unitrust does not affect a provision in the governing instrument directing or authorizing the trustee to distribute principal or authorizing a beneficiary to withdraw a portion or all of the principal.

(i) Prohibited conversions.--A trustee may not convert a trust into a unitrust in any of the following circumstances:

(1) If payment of the unitrust distribution would change the amount payable to a beneficiary as a fixed annuity or a fixed fraction of the value of the trust assets.

(2) If the unitrust distribution would be made from any amount which is permanently set aside for charitable purposes under the governing instrument and for which a Federal estate or gift tax deduction has been taken, unless both income and principal are so set aside.

(3) If:

(i) possessing or exercising the power to convert would cause an individual to be treated as the owner of all or part of the trust for Federal income tax purposes; and

(ii) the individual would not be treated as the owner if the trustee did not possess the power to convert.

(4) If:

(i) possessing or exercising the power to convert would cause all or part of the trust assets to be subject to Federal estate or gift tax with respect to an individual; and

(ii) the assets would not be subject to Federal estate or gift tax with respect to the individual if the trustee did not possess the power to convert.

(5) If the conversion would result in the disallowance of a Federal estate tax or gift tax marital deduction which would be allowed if the trustee did not have the power to convert.

(6) If the trustee is a beneficiary of the trust.

(j) Permissible conversion when otherwise prohibited.--

(1) If subsection (i)(3), (4) or (6) applies to a trustee and there is more than one trustee, a cotrustee to whom the provision does not apply may convert the trust, unless the exercise of the power by the remaining trustee or trustees is prohibited by the governing instrument.

(2) If subsection (i)(3), (4) or (6) applies to all the trustees, the trustees may petition the court to direct a conversion.

(k) Release of the power to convert.--

(1) A trustee may release the power conferred by subsection (a) to convert to a unitrust if any of the following apply:

(i) The trustee is uncertain about whether possessing or exercising the power will cause a result described in subsection (i)(3), (4) or (5).

(ii) The trustee determines that possessing or exercising the power will or may deprive the trust of a tax benefit or impose a tax burden not described in subsection (i).

(2) The release may be permanent or for a specified period, including a period measured by the life of an individual.

**Source Note: New.**

**Pennsylvania Comment: Section 8105. This section allows conversion to a unitrust, in which case the question of how to allocate receipts and disbursements between income and principal becomes irrelevant. The 4% unitrust is an alternative to using the power to adjust under section 8104 to determine the appropriate distribution to the current**

**beneficiary. Caveat: The federal income tax treatment of unitrusts is uncertain and converting a trust exempt from generation-skipping tax into a unitrust may result in a loss of the exemption. Subsection (g) is designed in part to allow the trustee by petition to the court to preserve this tax benefit.**

**Under section 8105(a)(2), since the unitrust may not be familiar to most beneficiaries, the trustee is required to notify them, and cannot convert to a unitrust in the face of an objection from a beneficiary without a court order.**

**Under section 8105(c), the list of factors to consider is parallel to the list in the prudent investor act in 20 Pa.C.S. § 7203(c).**

**Giving the trustee discretion under section 8105(e) seems preferable to creating a statutory straightjacket.**

**Section 8105(i), (j) and (k) parallel similar provisions in section 8104 regarding the power to adjust.**

§ 8106. Judicial control of discretionary powers.

(a) Standard of review.--A court shall not change a fiduciary's decision to exercise or not to exercise a discretionary power conferred by this chapter unless it determines that the decision was an abuse of the fiduciary's discretion.

(b) Remedies.--If a court determines that a fiduciary has abused its discretion regarding a discretionary power conferred by this chapter, the remedy is to restore the income and remainder beneficiaries to the positions they would have occupied if the fiduciary had not abused its discretion, according to the following rules:

(1) To the extent that the abuse of discretion has resulted in no distribution to a beneficiary or a distribution which is too small, the court shall require the fiduciary to distribute from the trust to the beneficiary an amount

that the court determines will restore the beneficiary, in whole or in part, to the beneficiary's appropriate position.

(2) To the extent that the abuse of discretion has resulted in a distribution to a beneficiary which is too large, the court shall restore the beneficiaries, the trust or both, in whole or in part, to their appropriate positions by requiring the fiduciary to withhold an amount from one or more future distributions to the beneficiary who received the distribution that was too large or requiring that beneficiary or that beneficiary's estate to return some or all of the distribution to the trust, notwithstanding a spendthrift or similar provision.

(3) If the abuse of discretion concerns the power to convert a trust into a unitrust, the court shall require the trustee either to convert into a unitrust or to reconvert from a unitrust.

(4) To the extent that the court is unable, after applying paragraphs (1), (2) and (3), to restore the beneficiaries, the trust or both to the positions they would have occupied if the fiduciary had not abused its discretion, the court may require the fiduciary to pay an appropriate amount from its own funds to one or more of the beneficiaries or the trust or both.

**Source Note: Section 105 of the Uniform Act.**

**Uniform Act Comment: *General.* All of the discretionary powers in the 1997 Act are subject to the normal rules that govern a fiduciary's exercise of discretion. Section 105 codifies those rules for purposes of the Act so that they will be readily apparent and accessible to fiduciaries, beneficiaries, their counsel and the courts if and when questions concerning such powers arise.**

**Section 105 (8105) also makes clear that the normal rules governing the exercise of a fiduciary's powers apply to the discretionary power to adjust conferred upon a trustee by section 104(a) (8104(a)). Discretionary provisions authorizing trustees to determine what is income and what is principal have been used in governing instruments for years; section 2 of the 1931 Uniform Principal and Income Act recognized that practice by providing that "the person establishing the principal may himself direct the manner of ascertainment of income and principal...or grant discretion to the trustee or other person to do so... ." Section 103(a)(2) (8103(a)(2)) recognizes the power of a settlor to grant such discretion to the trustee; section 105 (8105) applies to a discretionary power granted by the terms of a trust or a will and to the power to adjust in section 104(a) (8104(a)).**

**The exercise of the power to adjust is governed by a trustee's duty of impartiality, which requires the trustee to strike an appropriate balance between the interests of the income and remainder beneficiaries. Section 103(b) (8103(b)) expresses this duty by requiring the trustee to "administer a trust or estate impartially, based on what is fair and reasonable to all of the beneficiaries, except to the extent that the terms of the trust or the will clearly manifest an intention that the fiduciary shall or may favor one or more of the beneficiaries." Because this involves the exercise of judgment in circumstances rarely capable of perfect resolution, trustees are not expected to achieve perfection; they are, however, required to make conscious decisions in good faith and with proper motives.**

**In seeking the proper balance between the interests of the beneficiaries in matters involving principal and income, a trustee's traditional approach has been to determine the settlor's objectives from the terms of the trust, gather the information needed to ascertain the financial circumstances of the beneficiaries, determine the extent to which the settlor's objectives can be achieved with the resources available in the trust, and then allocate the trust's assets between stocks and fixed-income securities in a way that will produce a particular level or range of income for the income beneficiary. The key element in this process has been to determine the appropriate level or range of income for the income beneficiary, and that will continue to be the key element in deciding whether and to what extent to exercise the discretionary power conferred by**

section 104(a) (8104(a)). If it becomes necessary for a court to determine whether an abuse of the discretionary power to adjust between principal and income has occurred, the criteria should be the same as those that courts have used in the past to determine whether a trustee has abused its discretion in allocating the trust's assets between stocks and fixed-income securities.

*General rule.* The first sentence of section 105(a) (8105(a)) is from Restatement (Second) of Trusts § 187 and Restatement (Third) of Trusts (Tentative Draft No. 2, 1999), § 50(1). The second sentence of section 105(a) (8105(a)) derives from Comment *e* to § 187 of the Second Restatement and Comment *b* to § 50 of the Third Restatement.

The reference in section 105(a) (8105(a)) to a fiduciary's decision to exercise or not to exercise a discretionary power underscores a fundamental precept, which is that a fiduciary has a duty to make a conscious decision about exercising or not exercising a discretionary power. Comment *b* to § 50 of the Third Restatement states:

[A] court will intervene where the exercise of a power is left to the judgment of a trustee who improperly fails to exercise that judgment. Thus, even where a trustee has discretion whether or not to make any payments to a particular beneficiary, the court will interpose if the trustee, arbitrarily or without knowledge of or inquiry into relevant circumstances, fails to exercise the discretion.

Section 105(b) (8105(b)) makes clear that the rule of subsection (a) applies not only to the power conferred by section 104(a) (8104(a)) but also to the evaluation process required by section 104(b) (8104(b)) in deciding whether and to what extent to exercise the power to adjust. Under section 104(b) (8104(b)), a trustee is to consider all of the factors that are relevant to the trust and its beneficiaries, including, to the extent the trustee determines they are relevant, the nine factors enumerated in section 104(b) (8104(b)). Section 104(b) (8104(b)) derives from section 2(c) of the Uniform Prudent Investor Act, which lists eight circumstances that a trustee shall consider, to the extent they are relevant, in investing and managing assets. The trustee's decisions about what factors are relevant for purposes



of section 104(b) (8104(b)) and the weight to be accorded each of the relevant factors are part of the discretionary decision-making process. As such, these decisions are not subject to change for the purpose of changing the trustee's ultimate decision unless the court determines that there has been an abuse of discretion in determining the relevancy and weight of these factors.

*Remedy.* The exercise or nonexercise of a discretionary power under the Act normally affects the amount or timing of a distribution to the income or remainder beneficiaries. The primary remedy under section 105(c) (8105(b)) for abuse of discretion is the restoration of the beneficiaries and the trust to the positions they would have occupied if the abuse had not occurred. It draws on a basic principle of restitution that if a person pays money to someone who is not intended to receive it (and in a case to which this Act applies, not intended by the settlor to receive it in the absence of an abuse of discretion by the trustee), that person is entitled to restitution on the ground that the payee would be unjustly enriched if he were permitted to retain the payment. See Restatement of Restitution § 22 (1937). The objective is to accomplish the restoration initially by making adjustments between the beneficiaries and the trust to the extent possible; to the extent that restoration is not possible by such adjustments, a court may order the trustee to pay an amount to one or more of the beneficiaries, the trust, or both the beneficiaries and the trust. If the court determines that it is not possible in the circumstances to restore them to their appropriate positions, the court may provide other remedies appropriate to the circumstances. The approach of section 105(c) (8105(b)) is supported by Comment *b* to § 50 of the Third Restatement of Trusts:

When judicial intervention is required, a court may direct the trustee to make or refrain from making certain payments; issue instructions to clarify the standards or guidelines applicable to the exercise of the power; or rescind the trustee's payment decisions, usually directing the trustee to recover amounts improperly distributed and holding the trustee liable for failure or inability to do so...

*Advance determinations.* Section 105(d) (8105(c)) employs the familiar remedy of the trustee's petition to the court for

instructions. It requires the court to determine, upon a petition by the fiduciary, whether a proposed exercise or nonexercise of a discretionary power by the fiduciary of a power conferred by the Act would be an abuse of discretion under the general rule of section 105(a) (8105(a)). If the petition contains the information prescribed in the second sentence of subsection (d), the proposed action or inaction is presumed not to result in an abuse, and a beneficiary who challenges the proposal must establish that it will.

Subsection (d) is intended to provide a fiduciary the opportunity to obtain an assurance of finality in a judicial proceeding before proceeding with a proposed exercise or nonexercise of a discretionary power. Its purpose is not, however, to have the court instruct the fiduciary how to exercise the discretion.

A fiduciary may also obtain the consent of the beneficiaries to a proposed act or an omission to act, and a beneficiary cannot hold the fiduciary liable for that act or omission unless:

- (a) the beneficiary was under an incapacity at the time of such consent or of such act or omission; or
- (b) the beneficiary, when he gave his consent, did not know of his rights and of the material facts which the trustee knew or should have known and which the trustee did not reasonably believe that the beneficiary knew; or
- (c) the consent of the beneficiary was induced by improper conduct of the trustee.

Restatement (Second) of Trusts § 216.

If there are many beneficiaries, including some who are incapacitated or unascertained, the fiduciary may prefer the greater assurance of finality provided by a judicial proceeding that will bind all persons who have an interest in the trust.

**Pennsylvania Comment:** Section 8106(a). The Uniform Act provision that a court should not determine that a trustee abused its discretion merely because the court would have exercised the discretion differently is omitted as unnecessary.

**Section (b) of the Uniform Act lists the determinations to which subsection (a) applies. This has been omitted as unnecessary.**

**Subsection (d) of the Uniform Act allows the trustee to obtain an advisory opinion. It is omitted because it is inconsistent with Pennsylvania law, which does not permit the courts to give advisory opinions.**

§ 8107. (Reserved).

§ 8108. (Reserved).

§ 8109. (Reserved).

§ 8110. (Reserved).

§ 8111. (Reserved).

§ 8112. (Reserved).

§ 8113. Charitable trusts.

(a) Election.--Notwithstanding the foregoing provisions of this chapter, the trustee of a trust held exclusively for charitable purposes may elect to be governed by this section unless the governing instrument expressly provides that the election provided by this section shall not be available.

(b) Eligibility for election.--To make an election under this section, the trustee shall adopt and follow an investment policy seeking a total return for the investments held by the trust, whether the return is to be derived from appreciation of capital or earnings and distributions with respect to capital or both. The policy constituting the election shall be in writing, shall be maintained as part of the permanent records of the trust and shall recite that it constitutes an election to be governed by this section.

(c) Effect of election.--If an election is made to be governed by this section, the term "income" shall mean a percentage of the value of the trust. The trustee shall in a writing maintained as part of the permanent records of the trust annually select the percentage and determine that it is consistent with the long-term preservation of the real value of the principal of the trust, but in no event shall the percentage be less than 2% nor more than 7% per year. The term "principal" shall mean all other assets held by the trustee with respect to the trust.

(d) Revocation of election.--The trustee may revoke an election to be governed by this section if the revocation is made as part of an alternative investment policy seeking the long-term preservation of the real value of the principal of the trust. The revocation and alternative investment policy shall be in writing and maintained as part of the permanent records of the trust.

(e) Value determination.--For purposes of applying this section, the value of the trust shall be the fair market value of the cash and other assets held by the trustee with respect to the trust, whether such assets would be considered "income" or "principal" under the other provisions of this chapter, determined at least annually and averaged over a period of three or more preceding years. However, if the trust has been in existence less than three years, the average shall be determined over the period during which the trust has been in existence.

**Pennsylvania Note: Section 8113 is present Pennsylvania law and will be retained. It is replicated here for convenience.**

SUBCHAPTER B  
DECEDENT'S ESTATE OR  
TERMINATING INCOME INTEREST

Sec.

8121. Determination and distribution of net income.

8122. Distribution to residuary and remainder beneficiaries.

§ 8121. Determination and distribution of net income.

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

(1) A fiduciary of an estate or of a terminating income interest shall determine the amount of net income and net principal receipts received from property specifically given to a beneficiary under paragraph (5) and the provisions applicable to trustees in Subchapters C (relating to apportionment at beginning and end of income interest), D (relating to allocation of receipts during administration of trust) and E (relating to allocation of disbursements during administration of trust). The fiduciary shall distribute the net income and net principal receipts to the beneficiary who is to receive the specific property.

(2) A fiduciary shall distribute to a beneficiary who receives a pecuniary amount outright and shall allocate to a pecuniary amount in trust the interest, other income or other amount provided by the governing instrument or section 3543 (relating to interest or income on distributive shares) or 7187 (relating to

interest or income on distributive shares) from net income determined under paragraph (3) or from principal to the extent that net income is insufficient.

(3) A fiduciary shall determine the remaining net income of a decedent's estate or a terminating income interest under the provisions applicable to trustees in Subchapters C, D and E and by:

(i) including in net income all income from property used to discharge liabilities; and

(ii) paying from principal debts, funeral expenses, costs of disposition of remains, the family exemption, fees of personal representatives and their attorneys and accountants, and death taxes and related interest and penalties which are apportioned to the estate or terminating income interest by the governing instrument or applicable law.

(4) A fiduciary shall distribute the net income remaining after distributions required by paragraph (2) in the manner described in section 8122 (relating to distribution to residuary and remainder beneficiaries) to all other beneficiaries.

(5) A fiduciary may not reduce principal or income receipts from property described in paragraph (1) because of a payment described in section 8151 (relating to minerals, water and other natural resources) or 8152 (relating to timber) to the extent that the governing instrument or applicable law requires the fiduciary to make the payment from assets other than the property or to the extent that the fiduciary recovers or expects to recover the payment from a

third party. The net income and principal receipts from the property are determined by:

(i) including all of the amounts the fiduciary receives or pays with respect to the property, whether those amounts accrued or became due before, on or after the date of a decedent's death or an income interest's terminating event; and

(ii) making a reasonable provision for amounts that the fiduciary believes the estate or terminating income interest may become obligated to pay after the property is distributed.

**Source Note: Section 201 of the Uniform Act.**

**Uniform Act Comment: *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) (8121(3) and (4)) provide different rules for an outright gift of a pecuniary amount and a gift in trust of a pecuniary amount; this is the same approach used in section 5(b)(2) of the 1962 Act.

*Interest on pecuniary amounts.* Section 201(3) (8121(3)) provides that the beneficiary of an outright pecuniary amount is to receive the interest or other amount provided by applicable law if there is no provision in the will or the terms of the trust. Many States have no applicable law that provides for interest or some other amount to be paid on an outright pecuniary gift under an inter vivos trust; this section provides that in such a case the interest or other amount to be paid shall be the same as the interest or other amount required to be paid on testamentary pecuniary gifts. This provision is intended to accord gifts under inter vivos instruments the same treatment as testamentary gifts. The various state authorities that provide for the amount that a beneficiary of an outright pecuniary amount is entitled to receive are collected in Richard B. Covey, *Marital Deduction and Credit Shelter Dispositions and the Use of Formula Provisions*, App. B (4th ed. 1997).

*Administration expenses and interest on death taxes.* Under section 201(2)(B) (8121(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) (8121(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 contributions deduction, which means that the limit on the amount payable from income will be established eventually by Treasury Regulations.

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

**and interest on estate tax deficiencies will continue to be deductible for estate tax purposes if an election under section 6166 is not in effect.**

**Under the 1962 Act, section 13(c)(5) charges interest on estate and inheritance taxes to principal. The 1931 Act has no provision. Section 501(3) (8161) of this Act provides that, except to the extent provided in section 201(2)(B) or (C) (8121(2)(ii)), all interest must be paid from income.**

**Pennsylvania Comment: Section 8121. Section 201(2)(B) of the Uniform Act gives a personal representative discretion to pay the executor's fee, legal fees, court costs and interest on death taxes from income or principal, so that if those decisions are consistent with the tax deduction decisions made by the personal representative, no adjustments between income and principal need be made. It seems better to follow the rules of Subchapter E, subject always to the power to adjust, or not to adjust, under section 8104.**

**Unless the governing instrument provides otherwise, the Uniform Act would allow pecuniary gifts in trust to share in the estate's or trust's net income. The Pennsylvania version rejects this concept in favor of statutory interest, thereby preserving current law.**

§ 8122. Distribution to residuary and remainder beneficiaries.

(a) Distribution of net income.--Each beneficiary described in section 8121(4) (relating to determination and distribution of net income) is entitled to receive a portion of the net income equal to the beneficiary's fractional interest in undistributed principal assets, using values as of the distribution date. If a fiduciary makes more than one distribution of assets to beneficiaries to whom this section applies, each beneficiary, including one who does not receive part of the distribution, is entitled, as of each distribution date, to the net income the

fiduciary has received after the date of death or terminating event or earlier distribution date but has not distributed as of the current distribution date.

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

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

(2) The beneficiary's fractional interest in the undistributed principal assets must be calculated without regard to property specifically given to a beneficiary and property required to pay pecuniary amounts.

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

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

(d) Application.-- To the extent that the fiduciary considers it appropriate, if this section applies to the income from an asset, the fiduciary may apply the rules

in this section to net gain or loss from the disposition of a principal asset realized after the date of death or terminating event or earlier distribution date.

(e) Distribution date.--For purposes of this section, the distribution date may be the date as of which the fiduciary calculates the value of the assets if that date is reasonably near the date on which assets are actually distributed.

**Source Note: Section 202 of the Uniform Act.**

**Uniform Act Comment: *Relationship to prior acts.* Section 202 (8122) retains the concept in section 5(b)(2) of the 1962 Act that the residuary legatees of estates are to receive net income earned during the period of administration on the basis of their proportionate interests in the undistributed assets when distributions are made. It changes the basis for determining their proportionate interests by using asset values as of a date reasonably near the time of distribution instead of inventory values; it extends the application of these rules to distributions from terminating trusts; and it extends these rules to gain or loss realized from the disposition of assets during administration, an omission in the 1962 Act that has been noted by several commentators. See, e.g., Richard B. Covey, *Marital Deduction and Credit Shelter Dispositions and the Use of Formula Provisions* 91 (4th ed. 1998); Thomas H. Cantrill, *Fractional or Percentage Residuary Bequests: Allocation of Postmortem Income, Gain and Unrealized Appreciation*, 10 *Prob. Notes* 322, 327 (1985).**

SUBCHAPTER C

APPORTIONMENT AT BEGINNING

AND END OF INCOME INTEREST

Sec.

8131. When right to income begins and ends.

8132. Apportionment of receipts and disbursements when decedent dies or income interest begins.

8133. Apportionment when income interest ends.

§ 8131. When right to income begins and ends.

(a) Accrual of income interest.--An income beneficiary is entitled to net income from the date on which the income interest begins. An income interest begins:

(1) on the date specified in the governing instrument; or

(2) if no date is specified, on the date an asset becomes subject to a trust or successive income interest.

(b) Asset subject to a trust.--An asset becomes subject to a trust:

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

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

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

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

(d) End of income interest.--An income interest ends on:

(1) the day before an income beneficiary dies or another terminating event occurs; or

(2) the last day of a period during which there is no beneficiary to whom a trustee may distribute income.

**Source Note: Section 301 of the Uniform Act.**

**Uniform Act Comment: *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 (8132 and 8133) apply accordingly if the terms of the trust do not contain different provisions.**

§ 8132. Apportionment of receipts and disbursements when decedent dies or income interest begins.

(a) Allocation to principal.--Unless section 8121(1) (relating to determination and distribution of net income) applies, a trustee shall allocate an income receipt or disbursement to principal if its due date occurs before:

(1) a decedent dies in the case of an estate; or

(2) an income interest begins in the case of a trust or successive income interest.

(b) Allocation to income.--A trustee shall allocate an income receipt or disbursement to income if its due date occurs on or after the date on which a

decedent dies or an income interest begins and it is a periodic due date. An income receipt or disbursement must be treated as accruing from day to day if its due date is not periodic or it has no due date. The portion of the receipt or disbursement accruing before the date on which a decedent dies or an income interest begins must be allocated to principal and the balance must be allocated to income.

(c) Due dates.--An item of income or an obligation is due on the date the payor is required to make a payment. If a payment date is not stated, there is no due date for the purposes of this chapter. Distributions to shareholders or other owners from an entity to which section 8141 (relating to character of receipts) applies are deemed to be due on the date fixed by the entity for determining who is entitled to receive the distribution or, if no date is fixed, on the declaration date for the distribution. A due date is periodic for receipts or disbursements that must be paid at regular intervals under a lease or an obligation to pay interest or if an entity customarily makes distributions at regular intervals.

**Source Note: Section 302 of the Uniform Act.**

**Uniform Act Comment: *Prior acts.* Professor Bogert stated that “Section 4 of the [1962] Act makes a change with respect to the apportionment of the income of trust property not due until after the trust began but which accrued in part before the commencement of the trust. It treats such income as to be credited entirely to the income account in the case of a living trust, but to be apportioned between capital and income in the case of a testamentary trust. The [1931] Act apportions such income in the case of both types of trusts, except in the case of corporate dividends.” George G. Bogert, *The Revised Uniform Principal and Income Act*, 38 Notre Dame Law. 50, 52 (1962). The 1962 Act also provides that an asset passing to an inter**

vivos trust by a bequest in the settlor's will is governed by the rule that applies to a testamentary trust, so that different rules apply to assets passing to an inter vivos trust depending upon whether they were transferred to the trust during the settlor's life or by his will.

Having several different rules that apply to similar transactions is confusing. In order to simplify administration, section 302 (8132) applies the same rule to inter vivos trusts (revocable and irrevocable), testamentary trusts, and assets that become subject to an inter vivos trust by a testamentary bequest.

*Periodic payments.* Under section 302 (8132), a periodic payment is principal if it is due but unpaid before a decedent dies or before an asset becomes subject to a trust, but the next payment is allocated entirely to income and is not apportioned. Thus, periodic receipts such as rents, dividends, interest, and annuities, and disbursements such as the interest portion of a mortgage payment, are not apportioned. This is the original common law rule. Edwin A. Howes, Jr., *The American Law Relating to Income and Principal* 70 (1905). In trusts in which a surviving spouse is dependent upon a regular flow of cash from the decedent's securities portfolio, this rule will help to maintain payments to the spouse at the same level as before the settlor's death. Under the 1962 Act, the pre-death portion of the first periodic payment due after death is apportioned to principal in the case of a testamentary trust or securities bequeathed by will to an inter vivos trust.

*Nonperiodic payments.* Under the second sentence of section 302(b) (8132(b)), interest on an obligation that does not provide a due date for the interest payment, such as interest on an income tax refund, would be apportioned to principal to the extent it accrues before a person dies or an income interest begins unless the obligation is specifically given to a devisee or remainder beneficiary, in which case all of the accrued interest passes under section 201(1) (8121(1)) to the person who receives the obligation. The same rule applies to interest on an obligation that has a due date but does not provide for periodic payments. If there is no stated interest on the obligation, such as a zero coupon bond, and the proceeds from the obligation are received more than one year after it is purchased or



**acquired by the trustee, the entire amount received is principal under section 406 (8146).**

§ 8133. Apportionment when income interest ends.

(a) End of mandatory income interest.--When a mandatory income interest ends, the trustee shall pay to a mandatory income beneficiary who survives that date, or the estate of a deceased mandatory income beneficiary whose death causes the interest to end, the beneficiary's share of the undistributed income which is not disposed of under the governing instrument unless the beneficiary has an unqualified power to revoke more than 5% of the trust immediately before the income interest ends. In the latter case, the undistributed income from the portion of the trust that may be revoked shall be added to principal.

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

(c) Definition.--In this section, "undistributed income" means net income received before the date on which an income interest ends. The term does not include an item of income or expense which is due or accrued or net income which has been added or is required to be added to principal under the governing instrument.

**Source Note: Section 303 of the Uniform Act.**

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

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

*Example -- accrued periodic payments.* The rules in section 302 (8132) and section 303 (8133) work in the following manner: Assume that a periodic payment of rent that is due on July 20 has not been paid when an income interest ends on July 30; the successive income interest begins on July 31, and the rent payment that was due on July 20 is paid on August 3. Under section 302(a) (8132(a)), the July 20 payment is added to the principal of the successive income interest when received. Under section 302(b) (8132(b)), the entire periodic payment of rent that is due on August 20 is income when received by the successive income interest. Under section 303 (8133), neither the income beneficiary of the terminated income interest nor the beneficiary's estate is entitled to any part of either the July 20 or the August 20 payments because neither one was received before the income interest ended on July 30. The same principles apply to expenses of the trust.

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

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

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

#### SUBCHAPTER D

#### ALLOCATION OF RECEIPTS DURING

#### ADMINISTRATION OF TRUST

Sec.

8141. Character of receipts.

8142. Distribution from trust or estate.

8143. Business and other activities conducted by trustee.

8144. Principal receipts.

8145. Rental property.

8146. Obligation to pay money.

8147. Insurance policies and similar contracts.

8148. Insubstantial allocations not required.

8149. Retirement benefits, individual retirement accounts, deferred compensation, annuities and similar payments.

8150. Liquidating asset.

8151. Minerals, water and other natural resources.

8152. Timber.

8153. Property not productive of income.

8154. Derivatives and options.

8155. Asset-backed securities.

§ 8141. Character of receipts.

(a) Allocation to income.--Except as otherwise provided in this section, a trustee shall allocate to income money received from an entity including reinvested cash dividends.

(b) Allocation to principal.--A trustee shall allocate the following receipts from an entity to principal:

(1) Property other than money excluding reinvested cash dividends.

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

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

(4) Money received from an entity that is a regulated investment company or a real estate investment trust if the money distributed is a short-term or long-term capital gain dividend for Federal income tax purposes.

(c) When received in partial liquidation.--Money is received in partial liquidation:

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

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

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

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

(f) Definition.--In this section, "entity" means a corporation, partnership, limited liability company, regulated investment company, real estate investment

trust, common trust fund or any other organization, in which a trustee has an interest other than:

(1) a trust or estate to which section 8142 (relating to distribution from trust or estate) applies;

(2) a business or activity to which section 8143 (relating to business and other activities conducted by trustee) applies;

(3) a payment to which section 8149 (relating to retirement benefits, individual retirement accounts, deferred compensation, annuities and similar payments) applies; or

(4) an asset-backed security to which section 8155 (relating to asset-backed securities) applies.

**Source Note: Section 401 of the Uniform Act.**

**Uniform Act Comment: *Entities to which section 401 (8141) applies.* The reference to partnerships in section 401(a) (8141(f)) is intended to include all forms of partnerships, including limited partnerships, limited liability partnerships, and variants that have slightly different names and characteristics from State to State. The section does not apply, however, to receipts from an interest in property that a trust owns as a tenant in common with one or more co-owners, nor would it apply to an interest in a joint venture if, under applicable law, the trust's interest is regarded as that of a tenant in common.**

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

***Reinvested dividends.*** If a trustee elects (or continues an election made by its predecessor) to reinvest dividends in shares of stock of a distributing corporation or fund, whether evidenced by new certificates or entries on the books of the distributing entity, the new shares would be principal. Making or continuing such an election would be equivalent to deciding under section 104 (8104) to transfer income to principal in order to comply with section 103(b) (8103(b)). However, if the trustee makes or continues the election for a reason other than to comply with section 103(b) (8103(b)), e.g., to make an investment without incurring brokerage commissions, the trustee should transfer cash from principal to income in an amount equal to the reinvested dividends.

***Distribution of property.*** The 1962 Act describes a number of types of property that would be principal if distributed by a corporation. This becomes unwieldy in a section that applies to both corporations and all other entities. By stating that principal includes the distribution of any property other than money, section 401 (8141) embraces all of the items enumerated in section 6 of the 1962 Act as well as any other form of nonmonetary distribution not specifically mentioned in that Act.

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

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

**sold an investment asset; or because it sold a business asset other than one held for sale to customers in the normal course of its business and did not replace it; or it borrowed a large sum of money and secured the repayment of the loan with a substantial asset; or a principal source of its cash was from assets such as mineral interests, 90% of which would have been allocated to principal if the trust had owned the assets directly. In such a case the trustee, after considering the total return from the portfolio as a whole and the income component of that return, may decide to exercise the power under section 104(a) (8104(a)) to make an adjustment between income and principal, subject to the limitations in section 104(c) (8104(c)).**

**Pennsylvania Comment: Section 8141. The Uniform Act treats cash dividends used to purchase additional shares as principal for administrative convenience. It seems preferable to treat them for what they are, namely income.**

§ 8142. Distribution from trust or estate.

A trustee shall allocate to income an amount received as a distribution of income from a trust or an estate in which the trust has an interest other than a purchased interest and shall allocate to principal an amount received as a distribution of principal from such a trust or estate. If a trustee purchases an interest in a trust that is an investment entity, or a decedent or donor transfers an interest in such a trust to a trustee, section 8141 (relating to character of receipts) or 8155 (relating to asset-backed securities) applies to a receipt from the trust.

**Source Note: Section 402 of the Uniform Act.**

**Uniform Act Comment: *Terms of the distributing trust or estate.* Under section 103(a) (8103(a)), a trustee is to allocate receipts in accordance with the terms of the recipient trust or, if there is no provision, in accordance with this Act. However, in determining whether a distribution from another trust or an estate is income or principal, the trustee 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 to which section 415 (8155) applies. See John H. Langbein, *The Secret Life of the Trust: The Trust as an Instrument of Commerce*, 107 Yale L.J. 165 (1997).**

§ 8143. Business and other activities conducted by trustee.

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

(b) Net receipts.--

(1) A trustee that accounts separately for a business or other activity may determine the extent to which:

(i) its net cash receipts must be retained for working capital, the acquisition or replacement of fixed assets and other reasonably foreseeable needs of the business or activity; and

(ii) the remaining net cash receipts are accounted for as principal or income in the trust's general accounting records.

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

(c) Permissible activities for separate accounting.--Activities for which a trustee may maintain separate accounting records include:

- (1) Retail, manufacturing, service and other traditional business activities.
- (2) Farming.
- (3) Raising and selling livestock and other animals.
- (4) Management of rental properties.
- (5) Extraction of minerals and other natural resources.
- (6) Timber operations.
- (7) Activities to which section 8154 (relating to derivatives and options)

applies.

**Source Note: Section 403 of the Uniform Act.**

**Uniform Comment: *Purpose and scope.* The provisions in section 403 (8143) are intended to give greater flexibility to a trustee who operates a business or other activity in proprietorship form rather than in a wholly-owned corporation (or, where permitted by state law, a single-member limited liability company), and to facilitate the trustee's ability to decide the extent to which the net receipts from the activity should be allocated to income, just as the board of directors of**

a corporation owned entirely by the trust would decide the amount of the annual dividend to be paid to the trust. It permits a trustee to account for farming or livestock operations, rental properties, oil and gas properties, timber operations, and activities in derivatives and options as though they were held by a separate entity. It is not intended, however, to permit a trustee to account separately for a traditional securities portfolio to avoid the provisions of this Act that apply to such securities.

Section 403 (8143) permits the trustee to account separately for each business or activity for which the trustee determines separate accounting is appropriate. A trustee with a computerized accounting system may account for these activities in a “subtrust”; an individual trustee may continue to use the business and record-keeping methods employed by the decedent or transferor who may have conducted the business under an assumed name. The intent of this section is to give the trustee broad authority to select business record-keeping methods that best suit the activity in which the trustee is engaged.

If a fiduciary liquidates a sole proprietorship or other activity to which section 403 (8143) applies, the proceeds would be added to principal, even though derived from the liquidation of accounts receivable, because the proceeds would no longer be needed in the conduct of the business. If the liquidation occurs during probate or during an income interest’s winding up period, none of the proceeds would be income for purposes of section 201 (8121).

*Separate accounts.* A trustee may or may not maintain separate bank accounts for business activities that are accounted for under section 403 (8143). A professional trustee may decide not to maintain separate bank accounts, but an individual trustee, especially one who has continued a decedent’s business practices, may continue the same banking arrangements that were used during the decedent’s lifetime. In either case, the trustee is authorized to decide to what extent cash is to be retained as part of the business assets and to what extent it is to be transferred to the trust’s general accounts, either as income or principal.

§ 8144. Principal receipts.

A trustee shall allocate to principal any of the following:

(1) To the extent not allocated to income under this chapter, assets received from:

(i) a transferor during the transferor's lifetime;

(ii) a decedent's estate;

(iii) a trust with a terminating income interest; or

(iv) a payor under a contract naming the trust or its trustee as beneficiary.

(2) Money or other property received from a principal asset's sale, exchange, liquidation or change in form. This paragraph includes realized profit subject to this subchapter.

(3) Amounts recovered from third parties to reimburse the trust because of disbursements described in section 8162(a)(8) (relating to mandatory disbursements from principal) or for other reasons to the extent not based on the loss of income.

(4) Proceeds of property taken by eminent domain. A separate award made for the loss of income with respect to an accounting period during which a current income beneficiary had a mandatory income interest is income.

(5) Net income received in an accounting period during which there is no beneficiary to whom a trustee may or must distribute income.

(6) Other receipts as provided in sections 8148 (relating to insubstantial allocations not required) through 8155 (relating to asset-backed securities).

**Source Note: Section 404 of the Uniform Act.**

**Uniform Act Comment: *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. The rule is the same in the 1931 and 1962 Acts.**

§ 8145. Rental property.

(a) Rent.--To the extent that a trustee accounts for receipts from rental property pursuant to this section, the trustee shall allocate to income an amount received as rent of real or personal property. This subsection includes an amount received for cancellation or renewal of a lease.

(b) Deposit.--An amount received as a refundable deposit, including a security deposit or a deposit which is to be applied as rent for future periods:

(1) shall be added to principal;

(2) shall be held subject to the terms of the lease; and

(3) is not available for distribution to a beneficiary until the trustee's

contractual obligations have been satisfied with respect to that amount.

**Source Note: Section 405 of the Uniform Act.**

**Uniform Act Comment: *Application of section 403 (8143).* This section applies to the extent that the trustee does not account separately under section 403 (8143) for the management of rental properties owned by the trust.**

***Receipts that are capital in nature.* A portion of the payment under a lease may be a reimbursement of principal expenditures for improvements to the leased property that is**

**characterized as rent for purposes of invoking contractual or statutory remedies for nonpayment. If the trustee is accounting for rental income under section 405 (8145), a transfer from income to reimburse principal may be appropriate under section 504 (8165) to the extent that some of the “rent” is really a reimbursement for improvements. This set of facts could also be a relevant factor for a trustee to consider under section 104(b) (8104(b)) in deciding whether and to what extent to make an adjustment between principal and income under section 104(a) (8104(a)) after considering the return from the portfolio as a whole.**

§ 8146. Obligation to pay money.

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

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

(c) Application.--This section does not apply to an obligation to which any of the following apply:

(1) Section 8149 (relating to retirement benefits, individual retirement accounts, deferred compensation, annuities and similar payments).

(2) Section 8150 (relating to liquidating asset).

(3) Section 8151 (relating to minerals, water and other natural resources).

(4) Section 8152 (relating to timber).

(5) Section 8154 (relating to derivatives and options).

(6) Section 8155 (relating to asset-backed securities).

**Source Note: Section 406 of the Uniform Act.**

**Uniform Act Comment: *Variable or floating interest rates.* The reference in subsection (a) to variable or floating interest rate obligations is intended to clarify that, even though an obligation's interest rate may change from time to time based upon changes in an index or other market indicator, an obligation to pay money containing a variable or floating rate provision is subject to this section and is not to be treated as a derivative financial instrument under section 414 (8154).**

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

**Subsection (b) also applies to inflation-indexed bonds - any increase in principal due to inflation after issuance is principal upon redemption if the bond matures more than one year after**

**the trustee acquires it; if it matures within one year, all of the increase, including any attributable to an inflation adjustment, is income.**

***Effect of section 104 (8104).* In deciding whether and to what extent to exercise the power to adjust between principal and income granted by section 104(a) (8104(a)), a relevant factor for the trustee to consider is the effect on the portfolio as a whole of having a portion of the assets invested in bonds that do not pay interest currently.**

§ 8147. Insurance policies and similar contracts.

(a) General rule.--

(1) Except as otherwise provided in subsection (b) or (c), a trustee shall allocate to principal the proceeds of a life insurance policy or other contract in which the trust or its trustee is named as beneficiary. This paragraph includes a contract which insures the trust or its trustee against loss for damage to, destruction of or loss of title to a trust asset.

(2) If the premiums on the policy or contract are paid from income, the trustee shall allocate to income dividends on the policy or contract.

(3) If the premiums on the policy or contract are paid from principal, the trustee shall allocate to principal dividends on the policy or contract.

(b) Allocation of proceeds to income.--Except as provided in subsection (c), a trustee shall allocate to income proceeds of a contract which insures the trustee against any of the following:

- (1) Loss of occupancy or other use by an income beneficiary.
- (2) Loss of income.



(3) Subject to section 8143 (relating to business and other activities conducted by trustee), loss of profits from a business.

(c) Application.--This section does not apply to a contract to which section 8149 (relating to retirement benefits, individual retirement accounts, deferred compensation, annuities and similar payments) applies.

**Source Note: Section 407 of the Uniform Act.**

§ 8148. Insubstantial allocations not required.

If a trustee determines that an allocation between principal and income required by section 8149 (relating to retirement benefits, individual retirement accounts, deferred compensation, annuities and similar payments), 8150 (relating to liquidating asset), 8151 (relating to minerals, water and other natural resources), 8152 (relating to timber) or 8155 (relating to asset-backed securities) is insubstantial, the trustee may allocate the entire amount to principal unless one of the circumstances described in section 8104(c) (relating to trustee's power to adjust) applies to the allocation. This power may be exercised by a cotrustee in the circumstances described in section 8104(d) and may be released for the reasons and in the manner described in section 8104(e). An allocation is presumed to be insubstantial 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 5%; or

(2) the value of the asset producing the receipt for which the allocation would be made is less than 5% of the total value of the trust's assets at the beginning of the accounting period.

**Source Note: Section 408 of the Uniform Act.**

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

For example, assume that a trust's assets, which include a working interest in an oil well, have a value of \$1,000,000; the net income from the assets other than the working interest is \$40,000; and the net receipts from the working interest are \$400. The trustee may allocate all of the net receipts from the working interest to principal instead of allocating 10%, or \$40, to income under section 411 (8151). If the net receipts from the working interest are \$35,000, so that the amount allocated to income under section 411 (8151) would be \$3,500, the trustee may decide that this amount is sufficiently significant to the income beneficiary that the allocation provided for by section 411 (8151) should be made, even though the trustee is still permitted under section 408 (8148) to allocate all of the net receipts to principal because the \$3,500 would increase the net income of \$40,000, as determined before making an allocation under section 411 (8151), by less than 10%. Section 408 (8148) will also relieve a trustee from having to allocate net receipts from the sale of trees in a small woodlot between principal and income.

While the allocation to principal of small amounts under this section should not be a cause for concern for tax purposes, allocations are not permitted under this section in circumstances described in section 104(c) (8104(c)) to eliminate claims that the power in this section has adverse tax consequences.

**Pennsylvania Comment: Section 8148. Five percent is a more commonly used de minimus threshold than 10 percent.**

§ 8149. Retirement benefits, individual retirement accounts, deferred compensation, annuities and similar payments.

(a) General rule.--

(1) The trustee shall allocate to income the greater of:

(i) the portion of a payment characterized by the payor as interest or a dividend or a remittance in lieu of interest or a dividend; or

(ii) the portion of the payment characterized as imputed interest for Federal income tax purposes.

(2) The balance of any such payment shall be allocated to principal.

(b) Allocation under contract calling for equal installments.--

(1) If no part of a payment under a contract calling for equal installments over a fixed period of time is allocable to income under the provisions of subsection (a), the difference between the trust's acquisition value of the contract and the total expected return shall be deemed to be interest.

(2) The trustee shall allocate to income the portion of each payment equivalent to interest on the then unpaid principal balance at the rate specified in the contract or a rate necessary to thus amortize the difference between the expected return and the acquisition value, where that rate is readily ascertainable by the trustee.

(c) Allocation when internal net income of fund is readily ascertained.--

(1) If no portion of a payment from a separate fund held exclusively for the benefit of the trust is allocable to income under subsections (a) and (b) but

the internal net income of the fund determined as if the fund were a separate trust subject to Subchapters B (relating to decedent's estate or terminating income interest) through E (relating to allocation of disbursements during administration of trust) is readily ascertainable by the trustee, the portion of the payment equal to the then undistributed net income of the fund realized since the trust acquired its interest in the fund shall be deemed to be a distribution of such income and shall be allocated to the trust income account.

(2) The balance of any such payment shall be allocated to principal.

(d) When not otherwise allocable to income.--

(1) The trustee shall allocate to income 10% of the part of the payment which is required to be made during the accounting period and the balance to principal if:

(i) no part of the payment is allocable to income under subsection (a), (b) or (c); and

(ii) all or part of the payment is required to be made.

(2) The trustee shall allocate the entire payment to principal if :

(i) no part of a payment is required to be made; or

(ii) the payment received is the entire amount to which the trustee is entitled.

(3) For purposes of this subsection, a payment is not "required to be made" to the extent that it is made because the trustee exercises a right of withdrawal.

(e) Allocation to obtain marital deduction.--If, to obtain a Federal estate or gift tax marital deduction for a trust, the trustee must allocate more of a payment to income than provided for by this section, the trustee shall allocate to income the additional amount necessary to obtain the marital deduction.

(f) Application.--This section does not apply to payments to which section 8150 (relating to liquidating asset) applies.

(g) Definition.--In this section, “payment” means a payment that a trustee may receive over a fixed period of time or during the life of one or more individuals because of services rendered or property transferred to the payor in exchange for future payments. The term includes all of the following:

- (1) A payment made in money or property from:
  - (i) the payor’s general assets; or
  - (ii) a separate fund created by the payor or another.
- (2) A payment on or from:
  - (i) an installment contract or note;
  - (ii) a private or commercial annuity;
  - (iii) a deferred compensation agreement;
  - (iv) an employee death benefit;
  - (v) an individual retirement account; or
  - (vi) a pension, profit-sharing, stock or other bonus, or stock-ownership plan.

**Source Note: Section 409 of the Uniform Act.**

**Uniform Act Comment: Scope.** Section 409 (8149) applies to amounts received under contractual arrangements that provide for payments to a third party beneficiary as a result of services rendered or property transferred to the payor. While the right to receive such payments is a liquidating asset of the kind described in section 410 (8150) (i.e., “an asset whose value will diminish or terminate because the asset is expected to produce receipts for a period of limited duration”), these payment rights are covered separately in section 409 (8149) because of their special characteristics.

Section 409 (8149) applies to receipts from all forms of annuities and deferred compensation arrangements, whether the payment will be received by the trust in a lump sum or in installments over a period of years. It applies to bonuses that may be received over two or three years and payments that may last for much longer periods, including payments from an individual retirement account (IRA), deferred compensation plan (whether qualified or not qualified for special federal income tax treatment), and insurance renewal commissions. It applies to a retirement plan to which the settlor has made contributions, just as it applies to an annuity policy that the settlor may have purchased individually, and it applies to variable annuities, deferred annuities, annuities issued by commercial insurance companies, and “private annuities” arising from the sale of property to another individual or entity in exchange for payments that are to be made for the life of one or more individuals. The section applies whether the payments begin when the payment right becomes subject to the trust or are deferred until a future date, and it applies whether payments are made in cash or in kind, such as employer stock (in-kind payments usually will be made in a single distribution that will be allocated to principal under the second sentence of subsection (c)) (subsection (d)).

**The 1962 Act.** Under section 12 of the 1962 Act, receipts from “rights to receive payments on a contract for deferred compensation” are allocated to income each year in an amount “not in excess of 5% per year” of the property’s inventory value. While “not in excess of 5%” suggests that the annual allocation may range from zero to 5% of the inventory value, in practice the rule is usually treated as prescribing a 5% allocation. The inventory value is usually the present value of all the future payments, and since the inventory value is

determined as of the date on which the payment right becomes subject to the trust, the inventory value, and thus the amount of the annual income allocation, depends significantly on the applicable interest rate on the decedent's date of death. That rate may be much higher or lower than the average long-term interest rate. The amount determined under the 5% formula tends to become fixed and remain unchanged even though the amount received by the trust increases or decreases.

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

Section 409(b) does not apply to an IRA or an arrangement with payment provisions similar to an IRA. IRAs and similar arrangements are subject to the provisions in section 409(c) (8149(d)).

*Allocations under section 409(c) (8149(d)).* The focus of section 409 (8149), for purposes of allocating payments received by a trust to or between principal and income, is on the payment right rather than on assets that may be held in a fund from which the payments are made. Thus, if an IRA holds a portfolio of marketable stocks and bonds, the amount received by the IRA as dividends and interest is not taken into account in determining the principal and income allocation except to the extent that the Internal Revenue Service may require them

to be taken into account when the payment is received by a trust that qualifies for the estate tax marital deduction (a situation that is provided for in section 409(d)) (8149(e)). An IRA is subject to federal income tax rules that require payments to begin by a particular date and be made over a specific number of years or a period measured by the lives of one or more persons. The payment right of a trust that is named as a beneficiary of an IRA is not a right to receive particular items that are paid to the IRA, but is instead the right to receive an amount determined by dividing the value of the IRA by the remaining number of years in the payment period. This payment right is similar to the right to receive a unitrust amount, which is normally expressed as an amount equal to a percentage of the value of the unitrust assets without regard to dividends or interest that may be received by the unitrust.

An amount received from an IRA or a plan with a payment provision similar to that of an IRA is allocated under section 409(c) (8149(d)), which differentiates between payments that are required to be made and all other payments. To the extent that a payment is required to be made (either under federal income tax rules or, in the case of a plan that is not subject to those rules, under the terms of the plan), 10% of the amount received is allocated to income and the balance is allocated to principal. All other payments are allocated to principal because they represent a change in the form of a principal asset; section 409 (8149) follows the rule in section 404(2) (8144(2)), which provides that money or property received from a change in the form of a principal asset be allocated to principal.

Section 409(c) (8149(d)) produces an allocation to income that is similar to the allocation under the 1962 Act formula if the annual payments are the same throughout the payment period, and it is simpler to administer. The amount allocated to income under section 409 (8149) is not dependent upon the interest rate that is used for valuation purposes when the decedent dies, and if the payments received by the trust increase or decrease from year to year because the fund from which the payment is made increases or decreases in value, the amount allocated to income will also increase or decrease.



***Marital deduction requirements.*** When an IRA is payable to a QTIP marital deduction trust, the IRS treats the IRA as separate terminable interest property and requires that a QTIP election be made for it. In order to qualify for QTIP treatment, an IRS ruling states that all of the IRA's income must be distributed annually to the QTIP marital deduction trust and then must be allocated to trust income for distribution to the spouse. Rev. Rul. 89-89, 1989-2 C.B. 231. If an allocation to income under this Act of 10% of the required distribution from the IRA does not meet the requirement that all of the IRA's income be distributed from the trust to the spouse, the provision in subsection (d) (*subsection (e)*) requires the trustee to make a larger allocation to income to the extent necessary to qualify for the marital deduction. The requirement of Rev. Rul. 89-89 should also be satisfied if the IRA beneficiary designation permits the spouse to require the trustee to withdraw the necessary amount from the IRA and distribute it to her, even though the spouse never actually requires the trustee to do so. If such a provision is in the beneficiary designation, a distribution under subsection (d) (*subsection (e)*) should not be necessary.

***Application of section 104.*** Section 104(a) (*8104(a)*) of this Act gives a trustee who is acting under the prudent investor rule the power to adjust from principal to income if, considering the portfolio as a whole and not just receipts from deferred compensation, the trustee determines that an adjustment is necessary. See Example (5) in the Comment following section 104 (*8104*).

**Pennsylvania Comment:** Section 8149. Where the actual interest or its equivalent on the unpaid principal balance is specified or can be easily calculated it seems counterintuitive to resort to an arbitrary 10% rule, which in those cases severely distorts economic reality. Subsections (a) and (b) would provide such specific apportionment for notes or other installment contracts calling for level payments, a portion of which would be credited to interest on the then unpaid principal balance and the remaining portion to principal itself. A term certain annuity readily lends itself to the same amortization concept since the difference between the total expected return and the original acquisition value is substantially the equivalent of interest. Although an annuity conventionally does not specify an interest rate, both the

**effective interest rate and the resulting contract amortization schedule will be readily ascertained since in most cases it will be the same as the Applicable Federal Rate used in determining the acquisition value. Even in other cases, the unspecified interest rate can be readily ascertained from the acquisition value and the amount, frequency and duration of payment factors using one of many loan amortization programs commonly available in both financial software and on the Internet.**

**Most trustees or custodians of Individual Retirement Accounts (IRAs) and segregated 401(k) or HR-10 accounts render periodic statements which clearly reflect the interest and dividend income earned by the fund. Apportionment based on a presumed “pass through” of this income comes far closer to economic reality than an arbitrary allocation of 10% of a distribution which can range more or less from 1.3% to 50% of the underlying fund assets.**

**The presumption as to the source of a distribution should resolve the problem of undistributed income identification where the retirement plan keeps all assets in a single pot. It will also aid in identification of when and by whom an IRC 691(c) deduction may be claimed. Thus principal which bore the burden of the tax should enjoy the full benefit of the deduction therefor.**

§ 8150. Liquidating asset.

(a) Allocation.--A trustee shall allocate to income 10% of the receipts from a liquidating asset and the balance to principal.

(b) Definition.--As used in this section, the term “liquidating asset” means an asset the value of which will diminish or terminate because the asset is expected to produce receipts for a period of limited duration. 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 which does not provide for

the payment of interest on the unpaid balance. The term does not include any of the following:

(1) A payment subject to section 8149 (relating to retirement benefits, individual retirement accounts, deferred compensation, annuities and similar payments).

(2) Resources subject to section 8151 (relating to minerals, water and other natural resources).

(3) Timber subject to section 8152 (relating to timber).

(4) An activity subject to section 8154 (relating to derivatives and options).

(5) An asset subject to section 8155 (relating to asset-backed securities).

(6) An asset for which the trustee establishes a reserve for depreciation under section 8163 (relating to discretionary allocation of disbursements).

**Source Note: Section 410 of the Uniform Act.**

**Uniform Act Comment: *Prior acts.* Section 11 of the 1962 Act allocates 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 has a similar 5% rule that applies when the trustee is under a duty to change the form of the investment. The 5% rule imposes on a trust the obligation to pay a fixed annuity to the income beneficiary until the asset is exhausted. Under both the 1931 and 1962 Acts the balance of each year’s receipts is added to principal. A fixed payment can produce unfair results. 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 (8150) abandons the annuity approach under the 5% rule.**

***Lottery payments.* The reference in subsection (a) (subsection (b)) to rights to receive payments under an arrangement that does not provide for the payment of interest includes state lottery prizes and similar fixed amounts payable over time that are not deferred compensation arrangements covered by section 409 (section 8149).**

§ 8151. Minerals, water and other natural resources.

(a) Allocation for receipts from minerals and other natural resources.--To the extent that a trustee accounts for receipts from an interest in minerals or other natural resources under this section, the trustee shall allocate them as follows:

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

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

(3) If an amount received as a royalty, shut-in-well payment, take-or-pay payment, bonus or delay rental is more than nominal:

(i) sixty-six and two-thirds percent shall be allocated to principal; and

(ii) the balance shall be allocated to income.

(4) If an amount is received from a working interest or any other interest not provided for in paragraph (1), (2) or (3):

(i) sixty-six and two-thirds percent of the net amount received shall be allocated to principal; and

(ii) the balance shall be allocated to income.

(b) Allocation for receipts from water.--

(1) An amount received on account of an interest in renewable water shall be allocated to income.

(2) An amount received on account of an interest in nonrenewable water shall be allocated as follows:

(i) Sixty-six and two-thirds percent of the amount shall be allocated to principal.

(ii) The balance shall be allocated to income.

(c) Application.--This chapter applies whether or not a decedent or donor was extracting minerals, water or other natural resources before the interest became subject to the trust.

**Source Note: Section 411 of the Uniform Act.**

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

**Section 411 (8151) allocates 90% of the net receipts to principal and 10% to income. A depletion provision that is tied to past**

or present Code provisions is undesirable because it causes a large portion of the oil and gas receipts to be paid out as income. As wells are depleted, the amount received by the income beneficiary falls drastically. Allocating a larger portion of the receipts to principal enables the trustee to acquire other income producing assets that will continue to produce income when the mineral reserves are exhausted.

*Application of sections 403 and 408 (8143 and 8148).* This section applies to the extent that the trustee does not account separately for receipts from minerals and other natural resources under section 403 (8143) or allocate all of the receipts to principal under section 408 (8148).

*Open mine doctrine.* The purpose of section 411(c) (8151(c)) is to abolish the “open mine doctrine” as it may apply to the rights of an income beneficiary and a remainder beneficiary in receipts from the production of minerals from land owned or leased by a trust. Instead, such receipts are to be allocated to or between principal and income in accordance with the provisions of this Act. For a discussion of the open mine doctrine, see generally 3A Austin W. Scott & William F. Fratcher, *The Law of Trusts* §239.3 (4th ed. 1988), and *Nutter v. Stockton*, 626 P.2d 861 (Okla. 1981).

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

If the property is in a state other than the state where the trust is administered, the trustee must be aware that the law of the

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

**Pennsylvania Comment: Section 8151. The change in percentages is made to accord with present Pennsylvania law.**

§ 8152. Timber.

(a) Allocation of net receipts.--To the extent that a trustee accounts for receipts from the sale of timber and related products under this section, the trustee shall allocate the net receipts:

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

(2) To principal to the extent that:

(i) the amount of timber removed from the land exceeds the rate of growth of the timber; or

(ii) the net receipts are from the sale of standing timber.

(3) To or between income and principal, by determining the amount of timber removed from the land under the lease or contract and applying the rules in paragraphs (1) and (2) if the net receipts are from:

(i) the lease of timberland; or

(ii) a contract to cut timber from land owned by a trust.

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

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

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

**Source Note: Section 412 of the Uniform Act.**

**Uniform Comment: *Scope of section.* The rules in section 412 (8152) are intended to 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.**



***Application of sections 403 and 408 (8143 and 8148).*** This section applies to the extent that the trustee does not account separately for net receipts from the sale of timber and related products under section 403 (8143) or allocate all of the receipts to principal under section 408 (8148). The option to account for net receipts separately under section 403 (8143) takes into consideration the possibility that timber harvesting operations may have been conducted before the timber property became subject to the trust, and that it may make sense to continue using accounting methods previously established for the property. It also permits a trustee to use customary accounting practices for timber operations even if no harvesting occurred on the property before it became subject to the trust.

§ 8153. Property not productive of income.

(a) General rule.--If a Federal estate or gift tax marital deduction is allowed for all or part of a trust whose income is required to be paid to the settlor's or testator's spouse and whose assets consist substantially of property that does not provide the spouse with sufficient income from or use of the trust assets, and if the amounts that the trustee transfers from principal to income under section 8104 (relating to trustee's power to adjust) and that the trustee distributes to the spouse from principal pursuant to the governing instrument are insufficient to provide the spouse with the beneficial enjoyment required to obtain the marital deduction, the spouse may require the trustee to make property productive of income, convert property within a reasonable time, or exercise the power conferred by section 8104(a). The trustee may decide which action or combination of actions to take.

(b) Other cases.--In cases 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.

**Source Note: Section 413 of the Uniform Act.**

**Uniform Act Comment:** *Prior acts' conflict with Uniform Prudent Investor Act.* Section 2(b) of the Uniform Prudent Investor Act provides that “[a] trustee’s investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole ... .” The underproductive property provisions in section 12 of the 1962 Act and section 11 of the 1931 Act give the income beneficiary a right to receive a portion of the proceeds from the sale of underproductive property as “delayed income.” In each Act the provision applies on an asset by asset basis and not by taking into consideration the trust portfolio as a whole, which conflicts with the basic precept in section 2(b) of the Prudent Investor Act. Moreover, in determining the amount of delayed income, the prior Acts do not permit a trustee to take into account the extent to which the trustee may have distributed principal to the income beneficiary, under principal invasion provisions in the terms of the trust, to compensate for insufficient income from the unproductive asset. Under section 104(b)(7) (8104(b)(9)) of this Act, a trustee must consider prior distributions of principal to the income beneficiary in deciding whether and to what extent to exercise the power to adjust conferred by section 104(a) (8104(a)).

*Duty to make property productive of income.* In order to implement the Uniform Prudent Investor Act, this Act abolishes the right to receive delayed income from the sale proceeds of an asset that produces little or no income, but it does not alter existing state law regarding the income beneficiary’s right to compel the trustee to make property productive of income. As the law continues to develop in this area, the duty to make property productive of current income in a particular situation should be determined by taking into consideration the performance of the portfolio as a whole and the extent to which a trustee makes principal distributions to the income beneficiary under the terms of the trust and adjustments between principal and income under section 104 (8104) of this Act.

Trusts for which the value of the right to receive income is important for tax reasons may be affected by Reg. § 1.7520-3(b)(2)(v) *Example (1)*, § 20.7520-3(b)(2)(v) *Examples*

(1) and (2), and § 25.7520-3(b)(2)(v) *Examples (1) and (2)*, which provide that if the income beneficiary does not have the right to compel the trustee to make the property productive, the income interest is considered unproductive and may not be valued actuarially under those sections.

*Marital deduction trusts.* Subsection (a) draws on language in Reg. § 20.2056(b)-5(f)(4) and (5) to enable a trust for a spouse to qualify for a marital deduction if applicable state law is unclear about the spouse's right to compel the trustee to make property productive of income. The trustee should also consider the application of section 104 (8104) of this Act and the provisions of Restatement of Trusts 3d: Prudent Investor Rule § 240, at 186, app. § 240, at 252 (1992). Example (6) in the Comment to section 104 (8104) describes a situation involving the payment from income of carrying charges on unproductive real estate in which section 104 (8104) may apply.

Once the two conditions have occurred - insufficient beneficial enjoyment from the property and the spouse's demand that the trustee take action under this section -- the trustee must act; but instead of the formulaic approach of the 1962 Act, which is triggered only if the trustee sells the property, this Act permits the trustee to decide whether to make the property productive of income, convert it, transfer funds from principal to income, or to take some combination of those actions. The trustee may rely on the power conferred by section 104(a) (8104(a)) to adjust from principal to income if the trustee decides that it is not feasible or appropriate to make the property productive of income or to convert the property. Given the purpose of section 413 (8153), the power under section 104(a) (8104(a)) would be exercised to transfer principal to income and not to transfer income to principal.

Section 413 (8153) does not apply to a so-called "estate" trust, which will qualify for the marital deduction, even though the income may be accumulated for a term of years or for the life of the surviving spouse, if the terms of the trust require the principal and undistributed income to be paid to the surviving spouse's estate when the spouse dies. Reg. § 20.2056(c)-2(b)(1)(iii).

**Pennsylvania Comment:** Section 8153. The changes to this section are stylistic and clarifying only.

§ 8154. Derivatives and options.

(a) Derivatives.--To the extent that a trustee does not account under section 8143 (relating to business and other activities conducted by trustee) for transactions in derivatives, the trustee shall allocate to principal receipts from and disbursements made in connection with those transactions.

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

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

**Source Note: Section 414 of the Uniform Act.**

**Uniform Act Comment: *Scope and application.*** It is difficult to predict how frequently and to what extent trustees will invest directly in derivative financial instruments rather than participating indirectly through investment entities that may utilize these instruments in varying degrees. If the trust participates in derivatives indirectly through an entity, an amount received from the entity will be allocated under section 401 (8141) and not section 414 (8154). If a trustee invests directly in derivatives to a significant extent, the expectation is that receipts and disbursements related to derivatives will be accounted for under section 403 (8143); if a trustee chooses not to account under section 403 (8143), section 414(b) (8154(a)) provides the default rule. Certain types of option transactions in which trustees may engage are dealt with in subsection (c) (b) to distinguish those transactions from ones involving options that are embedded in derivative financial instruments.

**Definition of “derivative.”** “Derivative” is a difficult term to define because new derivatives are invented daily as dealers tailor their terms to achieve specific financial objectives for particular clients. Since derivatives are typically contract-based, a derivative can probably be devised for almost any set of objectives if another party can be found who is willing to assume the obligations required to meet those objectives.

The most comprehensive definition of derivative is in the Exposure Draft of a Proposed Statement of Financial Accounting Standards titled “Accounting for Derivative and Similar Financial Instruments and for Hedging Activities,” which was released by the Financial Accounting Standards Board (FASB) on June 20, 1996 (No. 162-B). The definition in section 414(a) (8154(c)) is derived in part from the FASB definition. The purpose of the definition in subsection (a) (d) is to implement the substantive rule in subsection (b) (a) that provides for all receipts and disbursements to be allocated to principal to the extent the trustee elects not to account for transactions in derivatives under section 403 (8143). As a result, it is much shorter than the FASB definition, which serves much more ambitious objectives.

A derivative is frequently described as including futures, forwards, swaps and options, terms that also require definition, and the definition in this Act avoids these terms. FASB used

the same approach, explaining in paragraph 65 of the Exposure Draft:

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

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

*Receipt of property other than cash.* If a trustee receives property other than cash upon the settlement of a derivatives transaction, that property would be principal under section 404(2) (8144(2)).

*Options.* Options to which subsection (c) (*subsection (b)*) applies include an option to purchase real estate owned by the trustee and a put option purchased by a trustee to guard against a drop in value of a large block of marketable stock that must be liquidated to pay estate taxes. Subsection (c) (*subsection (b)*) would also apply to a continuing and regular practice of selling call options on securities owned by the trust if the terms of the option require delivery of the securities. It

**does not apply if the consideration received or given for the option is something other than cash or property, such as cross-options granted in a buy-sell agreement between owners of an entity.**

§ 8155. Asset-backed securities.

(a) General rule.--If a trust receives a payment from interest or other current return and from other proceeds of the collateral financial assets:

(1) The trustee shall allocate to income the portion of the payment which the payor identifies as being from interest or other current return.

(2) The trustee shall allocate the balance of the payment to principal.

(b) Allocation where liquidating trust's interest in security.--

(1) If a trust receives one or more payments in exchange for the trust's entire interest in an asset-backed security in one accounting period, the trustee shall allocate the payments to principal.

(2) If a payment is one of a series of payments which will result in the liquidation of the trust's interest in the security over more than one accounting period, the trustee shall allocate:

(i) ten percent of the payment to income; and

(ii) the balance to principal.

(c) Definition.--As used in this section, the term "asset-backed security" means an asset the value of which is based upon the right it gives the owner to receive distributions from the proceeds of financial assets which provide collateral for the security. The term includes an asset which gives the owner the right to receive from the collateral financial assets only the interest or other current return

or only the proceeds other than interest or current return. The term does not include an asset to which section 8141 (relating to character of receipts) or 8149 (relating to retirement benefits, individual retirement accounts, deferred compensation, annuities and similar payments) applies.

**Source Note: Section 415 of the Uniform Act.**

**Uniform Act Comment: *Scope of section.*** Typical asset-backed securities include arrangements in which debt obligations such as real estate mortgages, credit card receivables and auto loans are acquired by an investment trust and interests in the trust are sold to investors. The source for payments to an investor is the money received from principal and interest payments on the underlying debt. An asset-backed security includes an “interest only” or a “principal only” security that permits the investor to receive only the interest payments received from the bonds, mortgages or other assets that are the collateral for the asset-backed security, or only the principal payments made on those collateral assets. An asset-backed security also includes a security that permits the investor to participate in either the capital appreciation of an underlying security or in the interest or dividend return from such a security, such as the “Primes” and “Scores” issued by Americus Trust. An asset-backed security does not include an interest in a corporation, partnership, or an investment trust described in the Comment to section 402 (8142), whose assets consist significantly or entirely of investment assets. Receipts from an instrument that do not come within the scope of this section or any other section of the Act would be allocated entirely to principal under the rule in section 103(a)(4) (8103(a)(4)), and the trustee may then consider whether and to what extent to exercise the power to adjust in section 104 (8104), taking into account the return from the portfolio as whole and other relevant factors.

SUBCHAPTER E

ALLOCATION OF DISBURSEMENTS DURING

ADMINISTRATION OF TRUST



Sec.

8161. Mandatory disbursements from income.

8162. Mandatory disbursements from principal.

8163. Discretionary allocation of disbursements.

8164. Transfers from income to principal for depreciation.

8165. Transfers from income to reimburse principal.

8166. Income taxes.

8167. Adjustments between principal and income because of taxes.

§ 8161. Mandatory disbursements from income.

A trustee shall make the following disbursements from income:

(1) Interest, except interest on death taxes.

(2) Ordinary repairs.

(3) Real estate and other regularly recurring taxes assessed against principal.

(4) Recurring premiums on fire or other insurance covering the loss of a principal asset or the loss of income from, or use of, the asset.

**Source Note: Section 501 of the Uniform Act.**

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

***Insurance premiums.* The reference in paragraph (4) to "recurring" premiums is intended to distinguish premiums paid annually for fire insurance from premiums on title insurance, each of which covers the loss of a principal asset. Title insurance premiums would be a principal disbursement under section 502(a)(5) (8152(a)(5)).**

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

**Pennsylvania Comment:** See Pennsylvania Comment following section 8163.

§ 8162. Mandatory disbursements from principal.

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

(1) Extraordinary expenses incurred in connection with the administration, management or preservation of trust property and the distribution of income.

(2) Extraordinary repairs.

(3) Compensation for legal services to the trustee.

(4) Expenses in connection with accountings and judicial or other proceedings. This paragraph includes proceedings to construe, modify or reform the trust or to protect the trust or its property.

(5) Payments on the principal of a trust debt.

(6) Premiums paid on a policy of insurance not described in section 8161(4) (relating to mandatory disbursements from income) of which the trust is the owner and beneficiary.

(7) Estate, inheritance and other transfer taxes, including interest and penalties, apportioned to the trust.

(8) Disbursements related to environmental matters. This paragraph includes:

- (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 those activities.
- (vii) Penalties imposed under environmental statutes or regulations and other payments made to comply with those statutes or regulations.
- (viii) Statutory or common law claims by third parties.
- (ix) Defending claims based on environmental matters.

(b) Mandatory reimbursement.--If a principal asset is encumbered with an obligation which requires income from that asset to be paid directly to the creditor, the trustee 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.

**Source Note: Section 502 of the Uniform Act.**

**Uniform Act Comment: *Environmental expenses.* All environmental expenses are payable from principal, subject to the power of the trustee to transfer funds to principal from income under section 504 (8165). However, the Drafting Committee decided that it was not necessary to broaden this provision to cover other expenditures made under compulsion of governmental authority. See generally the annotation at 43 A.L.R.4th 1012 (Duty as Between Life Tenant and**

**Remainderman with Respect to Cost of Improvements or Repairs Made Under Compulsion of Governmental Authority).**

Environmental expenses paid by a trust are to be paid from principal under section 502(a)(7) (8162(a)(8)) on the assumption that they will usually be extraordinary in nature. Environmental expenses might be paid from income if the trustee is carrying on a business that uses or sells toxic substances, in which case environmental cleanup costs would be a normal cost of doing business and would be accounted for under section 403 (8143). In accounting under that section, environmental costs will be a factor in determining how much of the net receipts from the business is trust income. Paying all other environmental expenses from principal is consistent with this Act's approach regarding receipts-- when a receipt is not clearly a current return on a principal asset, it should be added to principal because over time both the income and remainder beneficiaries benefit from this treatment. Here, allocating payments required by environmental laws to principal imposes the detriment of those payments over time on both the income and remainder beneficiaries.

Under sections 504(a) (8165(a)) and 504(b)(5) (8165(b)), a trustee who makes or expects to make a principal disbursement for an environmental expense described in section 502(a)(8) (8162(a)(8)) is authorized to transfer an appropriate amount from income to principal to reimburse principal for disbursements made or to provide a reserve for future principal disbursements.

The first part of section 502(a)(8) (8162(a)(8)) is based upon the definition of an "environmental remediation trust" in Treas. Reg. § 301.7701-4(e)(as amended in 1996). This is not because the Act applies to an environmental remediation trust, but because the definition is a useful and thoroughly vetted description of the kinds of expenses that a trustee owning contaminated property might incur. Expenses incurred to comply with environmental laws include the cost of environmental consultants, administrative proceedings and burdens of every kind imposed as the result of an administrative or judicial proceeding, even though the burden is not formally characterized as a penalty.

***Title proceedings.*** Disbursements that are made to protect a trust's property, referred to in section 502(a)(4) (8162(a)(4)), include an "action to assure title" that is mentioned in section 13(c)(2) of the 1962 Act.

***Insurance premiums.*** Insurance premiums referred to in section 502(a)(6) (8162(a)(6)) include title insurance premiums. They also include premiums on life insurance policies owned by the trust, which represent the trust's periodic investment in the insurance policy. There is no provision in the 1962 Act for life insurance premiums.

***Taxes.*** Generation-skipping transfer taxes are payable from principal under subsection (a)(7).

**Pennsylvania Comment:** See Pennsylvania Comment following section 8163.

§ 8163. Discretionary allocation of disbursements.

Subject to sections 8161 (relating to mandatory disbursements from income) and 8162 (relating to mandatory disbursements from principal), a trustee may, in the trustee's discretion, allocate to income or principal or partly to each ordinary expenses incurred in connection with the administration, management, or preservation of trust property and the distribution of income, including but not limited to the compensation of the trustee and of any person providing investment advisory, custodian or income tax return preparation services to the trustee.

**Source Note:** New.

**Pennsylvania Comment:** Sections 8161-8163 depart from the Uniform Act in the following ways:

**First, except as specifically listed in section 8161 ordinary expenses may be paid in the trustee's discretion from income or principal or partly from each. The Uniform Act provides that ordinary expenses must be paid from income.**

**Second, the fees of trustees, investment advisors and custodians may be allocated in the trustee's discretion between income and principal. The Uniform Act mandates they (and expenses of judicial proceedings) be allocated half to income and half to principal.**

**Third, the fees of income tax return preparers are specifically included along with the fees of trustees, investment advisors and custodians (so that they are allocable in the trustee's discretion).**

**Fourth, legal fees and expenses of accountings and legal proceedings are allocated to principal. The Uniform Act allocates these half to income and half to principal, or all to income if the proceeding concerns primarily the income interest.**

**Fifth, Pennsylvania's version explicitly states that extraordinary expenses are paid from principal. The Uniform Act does not expressly deal comprehensively with extraordinary expenses although it does suggest in section 8165(b) that extraordinary repairs are allocable to income.**

**These changes conform the Uniform Act to present Pennsylvania law.**

§ 8164. Transfers from income to principal for depreciation.

(a) Transfers.--A trustee may transfer to principal a reasonable amount of the net cash receipts from a principal asset that is subject to depreciation. However, a trustee may not transfer any amount for depreciation:

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

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

- (3) under this section if the trustee is accounting under section 8143 (relating to business and other activities conducted by trustee) for the business or activity in which the asset is used.
- (b) Separate fund unnecessary for amount transferred.--An amount transferred to principal need not be held as a separate fund.
- (c) Definition.--As used in this section, the term “depreciation” means a reduction in value due to wear, tear, decay, corrosion or gradual obsolescence of a fixed asset having a useful life of more than one year.

**Source Note: Section 503 of the Uniform Act.**

**Uniform Act Comment:** *Prior acts.* The 1931 Act has no provision for depreciation. Section 13(a)(2) of the 1962 Act provides that a charge shall be made against income for “... a reasonable allowance for depreciation on property subject to depreciation under generally accepted accounting principles ... .” That provision has been resisted by many trustees, who do not provide for any depreciation for a variety of reasons. One reason relied upon is that a charge for depreciation is not needed to protect the remainder beneficiaries if the value of the land is increasing; another is that generally accepted accounting principles may not require depreciation to be taken if the property is not part of a business. The Drafting Committee concluded that the decision to provide for depreciation should be discretionary with the trustee. The power to transfer funds from income to principal that is granted by this section is a discretionary power of administration referred to in section 103(b) (*8103(b)*), and in exercising the power a trustee must comply with section 103(b) (*8103(b)*).

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

**principal for depreciation is less than the amount of the principal payments.**

**Pennsylvania Comment: See Pennsylvania Comment following section 8167.**

§ 8165. Transfers from income to reimburse principal.

(a) Permissible reimbursements.--A trustee may transfer an appropriate amount from income to principal in one or more accounting periods to reimburse principal or to provide a reserve for future disbursements, if the trustee makes or expects to make a disbursement from principal which is allocable to income under section 8161 (relating to mandatory disbursements from income) or 8163 (relating to discretionary allocation of disbursements) and which:

(1) is paid from principal because it is unusually large; or

(2) is made to prepare property for rental, including tenant allowances, leasehold improvements, and broker's commissions.

(b) Continued transfers.--If the asset whose ownership gives rise to the disbursements becomes subject to a successive income interest after an income interest ends, a trustee may continue to transfer amounts from income to principal as provided in subsection (a).

(c) Application.--This section shall not apply to the extent the trustee has been or expects to be reimbursed by a third party.

**Source Note: Section 504 of the Uniform Act.**

**Uniform Act Comment: *Prior acts.* The sources of section 504 (8165) are section 13(b) of the 1962 Act, which permits a trustee to “regularize distributions,” if charges against income are unusually large, by using “reserves or other reasonable**



**means” to withhold sums from income distributions; section 13(c)(3) of the 1962 Act, which authorizes a trustee to establish an allowance for depreciation out of income if principal is used for extraordinary repairs, capital improvements and special assessments; and section 12(3) of the 1931 Act, which permits the trustee to spread income expenses of unusual amount “throughout a series of years.” Section 504 (8165) contains a more detailed enumeration of the circumstances in which this authority may be used, and includes in subsection (b)(4) the express authority to use income to make principal payments on a mortgage if the depreciation charge against income is less than the principal payments on the mortgage.**

**Pennsylvania Comment: See Pennsylvania Comment following section 8167.**

§ 8166. Income taxes.

(a) Receipts allocated to income.--A tax required to be paid by a trustee based on receipts allocated to income shall be paid from income.

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

(c) Tax on entity’s taxable income.--A tax required to be paid by a trustee on the trust’s share of an entity’s taxable income shall be paid proportionately:

(1) from income to the extent that receipts from the entity are allocated to income; and

(2) from principal to the extent that:

(i) receipts from the entity are allocated to principal; and

(ii) the trust’s share of the entity’s taxable income exceeds the total receipts described in paragraph (1) and subparagraph (i).

(d) Reductions in receipts allocated to principal or income.--For purposes of this section, receipts allocated to principal or income shall be reduced by the amount distributed to a beneficiary from principal or income for which the trust receives a deduction in calculating the tax.

**Source Note: Section 505 of the Uniform Act.**

**Uniform Act Comment: *Electing Small Business Trusts.* An Electing Small Business Trust (ESBT) is a creature created by Congress in the Small Business Job Protection Act of 1996 (P.L. 104-188). For years beginning after 1996, an ESBT may qualify as an S corporation stockholder even if the trustee does not distribute all of the trust's income annually to its beneficiaries. The portion of an ESBT that consists of the S corporation stock is treated as a separate trust for tax purposes (but not for trust accounting purposes), and the S corporation income is taxed directly to that portion of the trust even if some or all of that income is distributed to the beneficiaries.**

A trust normally receives a deduction for distributions it makes to its beneficiaries. Subsection (d) takes into account the possibility that an ESBT may not receive a deduction for trust accounting income that is distributed to the beneficiaries. Only limited guidance has been issued by the Internal Revenue Service, and it is too early to anticipate all of the technical questions that may arise, but the powers granted to a trustee in sections 506 (8167) and 104 (8104) to make adjustments are probably sufficient to enable a trustee to correct inequities that may arise because of technical problems.

**Pennsylvania Comment: See Pennsylvania Comment following section 8167.**

§ 8167. Adjustments between principal and income because of taxes.

A trustee may make adjustments between principal and income to offset the shifting of economic interests or tax benefits between income beneficiaries and remainder beneficiaries which arise from any of the following:

- (1) An election or decision which the trustee makes regarding tax matters.
- (2) An income tax or any other tax which is imposed upon the trustee or a beneficiary as a result of a transaction involving the trust or distribution from the trust.
- (3) The ownership by a trust of an interest in an entity the taxable income of which, whether or not distributed, is includable in the taxable income of the trust or a beneficiary.

**Source Note: Section 506 of the Uniform Act.**

**Uniform Act Comment: *Discretionary adjustments.* Section 506(a) (8167) permits the fiduciary to make adjustments between income and principal because of tax law provisions. It would permit discretionary adjustments in situations like these: (1) A fiduciary elects to deduct administration expenses that are paid from principal on an income tax return instead of on the estate tax return; (2) a distribution of a principal asset to a trust or other beneficiary causes the taxable income of an estate or trust to be carried out to the distributee and relieves the persons who receive the income of any obligation to pay income tax on the income; or (3) a trustee realizes a capital gain on the sale of a principal asset and pays a large state income tax on the gain, but under applicable federal income tax rules the trustee may not deduct the state income tax payment from the capital gain in calculating the trust's federal capital gain tax, and the income beneficiary receives the benefit of the deduction for state income tax paid on the capital gain. See generally Joel C. Dobris, *Limits on the Doctrine of Equitable Adjustment in Sophisticated Postmortem Tax Planning*, 66 Iowa L. Rev. 273 (1981).**

**Section 506(a)(3) (8167(3)) applies to a qualified Subchapter S trust (QSST) whose income beneficiary is required to include a pro rata share of the S corporation's taxable income in his return. If the QSST does not receive a cash distribution from the corporation that is large enough to cover the income beneficiary's tax liability, the trustee may distribute additional cash from principal to the income beneficiary. In this case the**

retention of cash by the corporation benefits the trust principal. This situation could occur if the corporation's taxable income includes capital gain from the sale of a business asset and the sale proceeds are reinvested in the business instead of being distributed to shareholders.

*Mandatory adjustment.* Subsection (b) provides for a mandatory adjustment from income to principal to the extent needed to preserve an estate tax marital deduction or charitable contributions deduction. It is derived from New York's EPTL § 11-1.2(A), which requires principal to be reimbursed by those who benefit when a fiduciary elects to deduct administration expenses on an income tax return instead of the estate tax return. Unlike the New York provision, subsection (b) limits a mandatory reimbursement to cases in which a marital deduction or a charitable contributions deduction is reduced by the payment of additional estate taxes because of the fiduciary's income tax election. It is intended to preserve the result reached in *Estate of Britenstool v. Commissioner*, 46 T.C. 711 (1966), in which the Tax Court held that a reimbursement required by the predecessor of EPTL § 11-1.2(A) resulted in the estate receiving the same charitable contributions deduction it would have received if the administration expenses had been deducted for estate tax purposes instead of for income tax purposes. Because a fiduciary will elect to deduct administration expenses for income tax purposes only when the income tax reduction exceeds the estate tax reduction, the effect of this adjustment is that the principal is placed in the same position it would have occupied if the fiduciary had deducted the expenses for estate tax purposes, but the income beneficiaries receive an additional benefit. For example, if the income tax benefit from the deduction is \$30,000 and the estate tax benefit would have been \$20,000, principal will be reimbursed \$20,000 and the net benefit to the income beneficiaries will be \$10,000.

*Irrevocable grantor trusts.* Under sections 671-679 of the Internal Revenue Code (the "grantor trust" provisions), a person who creates an irrevocable trust for the benefit of another person may be subject to tax on the trust's income or capital gains, or both, even though the settlor is not entitled to receive any income or principal from the trust. Because this is now a well-known tax result, many trusts have been created to produce this result, but there are also trusts that are

unintentionally subject to this rule. The Act does not require or authorize a trustee to distribute funds from the trust to the settlor in these cases because it is difficult to establish a rule that applies only to trusts where this tax result is unintended and does not apply to trusts where the tax result is intended. Settlers who intend this tax result rarely state it as an objective in the terms of the trust, but instead rely on the operation of the tax law to produce the desired result. As a result it may not be possible to determine from the terms of the trust if the result was intentional or unintentional. If the drafter of such a trust wants the trustee to have the authority to distribute principal or income to the settlor to reimburse the settlor for taxes paid on the trust's income or capital gains, such a provision should be placed in the terms of the trust. In some situations the Internal Revenue Service may require that such a provision be placed in the terms of the trust as a condition to issuing a private letter ruling.

**Pennsylvania Comment:** Sections 8164-8167. These sections generally follow the Uniform Act, which conforms to and clarifies present Pennsylvania law. Section 8165 omits the Uniform Act provision allowing transfers to principal for capital improvements, certain mortgage payments, and environmental costs, because these are properly principal charges. Section 506(b) is omitted because it applies to a limited situation and would complicate and change the practice of many practitioners. Clarifying stylistic changes have been made.

## SUBCHAPTERS F AND G

RESERVED

## SUBCHAPTER H

## MISCELLANEOUS PROVISIONS

Sec.

8191. Uniformity of application and construction.

§ 8191. Uniformity of application and construction.

In applying and construing this chapter, consideration shall be given to the need to promote uniformity of the law with respect to its subject matter among states which enact it.

**Source Note: Section 601 of the Uniform Act.**

## CONFORMING AMENDMENTS

§ 3702. Equitable apportionment of Federal estate tax.

\* \* \*

(h) Interest and penalties.--Interest and penalties shall be apportioned in the same manner as the principal amount of the Federal estate tax [unless the court finds it inequitable to do so by reason of special circumstances in which case the court may direct a different apportionment of interest and penalties.] subject to a fiduciary's power to adjust under Ch. 81 (relating to principal and income).

§ 5536. Distributions of income and principal during incapacity.

(a) In general.--All income received by a guardian of the estate of an incapacitated person, including (subject to the requirements of Federal law relating thereto) all funds received from the Veterans' Administration, Social Security Administration and other periodic retirement or disability payments under private or governmental plans, in the exercise of a reasonable discretion, may be expended in the care and maintenance of the incapacitated person, without the necessity of court approval. The court, for cause shown and with only such notice as it considers appropriate in the circumstances, may authorize or direct the payment or application of any or all of the income or principal of the estate of an incapacitated person for the care, maintenance or education of the incapacitated person, his spouse, children or those for whom he was making such provision

before his incapacity, or for the reasonable funeral expenses of the incapacitated person's spouse, child or indigent parent. In proper cases, the court may order payment of amounts directly to the incapacitated person for his maintenance or for incidental expenses and may ratify payments made for these purposes. For purposes of this subsection, "income" means income as determined in accordance with the rules set forth in Ch. 81 (relating to principal and income), other than the power to adjust and the power to convert to a unitrust.

\* \* \*

§ 5164. Distributions for support and education.

All income received by a guardian of the estate of a minor, including, subject to the requirements of Federal law relating thereto, all funds received from the Department of Veterans' Affairs, Social Security Administration and other periodic retirement or disability payments under private or government plans, in the exercise of a reasonable discretion, may be expended in the care, maintenance and education of the minor without the necessity of court approval. The court, for cause shown and with only such notice as it considers appropriate in the circumstances, may authorize or direct the payment or application of any or all of the income or principal of the estate of a minor for the care, maintenance or education of the minor, his spouse or children, or for the reasonable funeral expenses of the minor's spouse, child or indigent parent. In proper cases, the court may order payment of amounts directly to the ward for his maintenance or for incidental expenses and may ratify payments made for these purposes. For



purposes of this section, “income” means income as determined in accordance with the rules set forth in Ch. 81 (relating to principal and income), other than the power to adjust and the power to convert to a unitrust.

TRANSITIONAL PROVISIONS OF  
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(1) Present 20 Pa.C.S. Ch. 81 is repealed. However, present section 8113 is reenacted without change.

(2) Except as otherwise expressly provided in the governing instrument or in the addition of 20 Pa.C.S. Ch. 81, this act shall apply to all of the following:

(i) A trust existing on or after the effective date of this act.

(ii) The estate of a decedent who dies on or after the effective date of this act.

(3) This act shall take effect in 60 days.

## **OTHER PROPOSED AMENDMENTS**

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§ 724. Situs of inter vivos trust.

(a) When provided for in trust instrument.--If the trust instrument expressly provides for the situs of the inter vivos trust, its situs shall be at the place within or without the Commonwealth which is in accord with such provision.

(b) Not provided for in trust instrument.--If the trust instrument does not expressly provide for the situs of the inter vivos trust, its situs shall be:

(1) Resident settlor.--In the case of an inter vivos trust whose settlor is domiciled in the Commonwealth:

(i) in the settlor's lifetime, either in the county of his principal residence or in the county in which any of the trustees resides or [is located] has a place of business; and

(ii) after the settlor's death, either in the county in which letters have been granted to his personal representative, or in a county in which letters could have been granted, or in a county which is the principal place of the trust's administration or in which any trustee resides [or is located] or has a place of business.

(2) Nonresident settlor.--In the case of an inter vivos trust whose settlor:

(i) is not domiciled in the Commonwealth at the time when during his lifetime the first application is made to a court concerning the trust; or

(ii) was not domiciled in the Commonwealth at his death if the first application to a court concerning the trust was made thereafter, in a county which is the principal place of the trust's administration or in which any trustee resides [or is located,] or has a place of business and if there is no such trustee, then in a county where property of the trust is located.

**Comment: The Uniform Trust Code uses the concept of principal place of the trust's administration as the primary basis for determining the situs of the trust. The changes to section 724 adopt this concept while retaining the existing alternatives of location of the trustee and location of the trust property. The location of the trustee alternative for a non-resident settlor is expanded to match that of a resident settlor and both are updated to use the Uniform Trust Code language of "has a place of business" instead of "is located."**

§ 2104. Rules of succession.

The provisions of this chapter shall be applied to both real and personal estate in accordance with the following rules:

\* \* \*

(11) Intestacy following valid prior estate.--In the event of an intestacy occurring at the termination of a valid prior estate, the identity and shares of the intestate heirs then entitled to take shall be ascertained as though the death of the testator, settlor or grantor had occurred at the time of the termination of the prior estate.

**Comment: This is intended to both resolve possible inconsistencies in judicial authority and adopt in intestacy situations the same practical solution as was previously reached in section 2514(4) relating to the time of ascertaining the class in a gift under a will to heirs or next of kin.**

§ 3701. Power of decedent.

A testator, settlor, donor or possessor of any appropriate power of appointment may direct how the Federal estate tax or the Federal generation-skipping transfer tax due because of his death, including interest and penalties, shall be apportioned or may grant a discretionary power to another so to direct, but:

(1) any direction regarding apportionment of the Federal generation-skipping transfer tax must expressly refer to that tax[.] ; and

(2) [Any] any direction waiving the right of recovery of Federal estate tax, provided for under section 2207A of the Internal Revenue Code of 1986 (Public Law 99-514, 26 U.S.C. § 2207A), on [the] property includable in the [taxable] gross estate by reason of section 2044 of the Internal Revenue Code of 1986, must expressly refer to that right.

Any such direction shall take precedence over the provisions of this chapter insofar as the direction provides for the payment of the tax or any part thereof from property the disposition of which can be controlled by the instrument containing the direction or delegating the power to another.

§ 3702. Equitable apportionment of Federal estate tax.

\* \* \*

(f) Additional Federal estate tax.--

(1) Any increase in Federal estate tax caused by the inclusion under section 2044 of the Internal Revenue Code of 1986 (Public Law 99-514, 26 U.S.C. § 2044) of a qualified terminable interest trust in the estate of a decedent shall be apportioned against that trust.

(2) Any increase in Federal estate tax caused by a taxable event occurring in a qualified domestic trust under section 2056A of the Internal Revenue Code of 1986 shall be apportioned against that trust notwithstanding the provisions of subsection (b) or (c).

(3) Any additional Federal estate tax due because a qualified heir disposes of qualified real property or ceases to use it for the qualified use shall be apportioned against the qualified heir notwithstanding the provisions of subsection (b).

**Comment: To be consistent with the requirements of the Internal Revenue Code relative to the burden of Federal estate tax on either a qualified terminal interest trust, or a qualified domestic trust, the share of tax to be apportioned thereto is to be calculated using the top marginal tax rate rather than the average rate which is otherwise generally applicable under Chapter 37.**

\* \* \*

(j) Gift tax.--Gift tax paid by the decedent and imposed on a gift by the decedent or his spouse within three years of the date of his death and included in

his gross estate shall be treated in the same manner as though the amount of such gift tax had been a preresiduary testamentary gift by the decedent to the donee of the gift.

**Comment:** The amount of gift tax paid on gifts made within three years of the date of death is includable in the gross estate for Federal estate tax purposes. Subsection (j) identifies the party deemed to be interested in such gift tax and the deemed nature of that interest so that the other apportionment rules of section 3702 can be properly applied thereto.

§ 5301. Short title of chapter and definitions.

\* \* \*

(b) Definitions.--The following words and phrases when used in this chapter shall have the meanings given to them in this subsection unless the context clearly indicates otherwise:

\* \* \*

“Minor.” An individual who has not attained 21 years of age[.] , except that when used with reference to the beneficiary for whose benefit custodial property is held or is to be held, an individual who has not attained the age at which the custodian is required under sections 5320 (relating to termination of custodianship) and 5321 (relating to delay in transfer of custodial property after minor attains age 21) to transfer the custodial property to the beneficiary.

\* \* \*

§ 5320. Termination of custodianship.

The custodian shall transfer in an appropriate manner the custodial property to the minor or the minor's estate upon the earlier of:

(1) the minor's attainment of 21 years of age with respect to custodial property transferred by gift under section 5304 (relating to transfer by gift or exercise of power of appointment) [or 5305 (relating to transfer authorized by will or trust)];

[(2) the minor's attainment of majority under the laws of this Commonwealth other than this chapter with respect to custodial property transferred under section 5306 (relating to other transfer by fiduciary) or 5307 (relating to transfer by obligor); or

(3) the minor's death.]

(2) the minor's attainment of 21 years of age with respect to a custodian nominated under section 5303 (relating to nomination of custodian) or with respect to custodial property transferred by exercise of power of appointment under section 5304 or by will or trust under section 5305 (relating to transfer authorized by will or trust), unless the time of transfer of the custodial property to the minor is delayed under section 5321 (relating to delay in transfer of custodial property after minor attains age 21) to a time after the minor attains 21 years of age;

(3) the time specified in the transfer pursuant to section 5309 (relating to manner of creating custodial property and effecting transfer) if the time of



transfer of the custodial property to the minor is delayed under section 5321 to a time after the time the minor attains 21 years of age;

(4) the minor's attainment of majority under the laws of this Commonwealth other than this chapter with respect to custodial property transferred under section 5306 (relating to other transfer by fiduciary) or 5307 (relating to transfer by obligor); or

(5) the minor's death.

§ 5321. Delay in transfer of custodial property after minor attains age 21.

(a) General rule.--Subject to the requirements and limitations of this section, the time for transfer to the minor of custodial property transferred under or pursuant to section 5303 (relating to nomination of custodian), 5304 (relating to transfer by gift or exercise of power of appointment) or 5305 (relating to transfer authorized by will or trust) may be delayed until a specified time after the time the minor attains 21 years of age, which time shall be specified in the transfer pursuant to section 5309 (relating to manner of creating custodial property and effecting transfer).

(b) How to specify a delayed time for transfer.--To specify a delayed time for transfer to the minor of the custodial property, the words "as custodian for (name of minor) until age (age for delivery of property to minor) under the Pennsylvania Uniform Transfers to Minors Act" shall be substituted in substance for the words "as custodian for (name of minor) under the Pennsylvania Uniform Transfers to Minors Act" in making the transfer pursuant to section 5309.

(c) Transfer authorized by will or trust; nomination of custodian.--The time for transfer to the minor of custodial property transferred under or pursuant to section 5303 or 5305 may be delayed under this section only if the governing will or trust or nomination provides in substance that the custodianship is to continue until the time the minor attains a specified age, which time may not be later than the time the minor attains 25 years of age, and in that case the governing will or trust or nomination shall determine the time to be specified in the transfer pursuant to section 5309.

(d) Transfer by exercise of power appointment.--The time for transfer to the minor of custodial property transferred by the irrevocable exercise of a power of appointment under section 5304 may be delayed under this section only if the transfer pursuant to section 5309 provides in substance that the custodianship is to continue until the time the minor attains a specified age, which time may not be later than the time the minor attains 25 years of age.

(e) When section not applicable.--This section shall not apply to the time for transfer to the minor of custodial property transferred by irrevocable gift under section 5304.

(f) When transfer does not specify age.--If the transfer pursuant to section 5309 does not specify any age, the time for the transfer of the custodial property to the minor under section 5320 (relating to termination of custodianship) is the time when the minor attains 21 years of age.

(g) When transfer provides for a longer duration of custodianship than permitted by this section.--If the transfer pursuant to section 5309 provides in substance that the duration of the custodianship is for a time longer than the maximum time permitted by this section for the duration of a custodianship created by that type of transfer, the custodianship shall be deemed to continue only until the time the minor attains the maximum age permitted by this section for the duration of a custodianship created by that type of transfer.

**Comment: This is taken almost verbatim from California Probate Code sections 3901, 3920 and 3920.5. There is no provision under the Uniform Transfers to Minors Act (1986) for choice as to the age at which custodial property shall be transferred to the minor. Likewise, there was no such provision under prior Pennsylvania law. This section gives this choice since many transferors want an easy way to have funds held after their deaths for children beyond age 21.**

**Subsection (c) permits the custodianship to continue until not later than the time the minor attains the age of 25 years where the transfer is made pursuant to a provision in a will, trust or life insurance beneficiary designation that provides that the custodianship is to continue until the specified age. A custodianship may be established pursuant to a provision in a will, trust or life insurance beneficiary designation that provides that the custodianship is to continue until a specified age after age 21 even though the beneficiary has attained an age older than 21 but younger than the specified age at which the custodianship is to terminate.**

**Subsection (e) does not permit the custodianship to continue until later than the time the minor attains the age of 21 years where the custodial property is transferred by a lifetime gift because of federal gift tax issues. The age 21 limit is consistent with the Internal Revenue Code which permits "minority trusts" under section 2503(c) of the Internal Revenue Code to continue in effect until age 21; use of any older age would render the gift ineligible for the federal gift tax annual exclusion.**

§ 6205. Effect of Disclaimer.

(a) In general.--A disclaimer relates back for all purposes to the date of the death of the decedent or the effective date of the inter vivos transfer or third-party beneficiary contract as the case may be. The disclaimer shall [be binding upon the disclaimant and all persons claiming through or under him.] not in any way diminish the interest of any person other than the disclaimant in such person's own right under the instrument creating the disclaimed interest or under the intestate laws nor diminish any interest to which such person becomes entitled under subsection (b) by reason of the disclaimer.

**Comment: This amendment is designed to preserve the intent of the original provision. That provision was not intended to diminish the interest of any person other than the disclaimant in the disclaimed property which such person acquired in his or her own right, as opposed to interests acquired “through or under the disclaimant.” The latter language appears to have been interpreted to bring about this unintended result in *McCutcheon Estate*, 699 A.2d 746 (Pa. Super. 1997). This change is intended explicitly to overrule the result in *McCutcheon* to the extent it so holds or carries any such implication. Any such result could seriously undermine the usefulness and effectiveness of disclaimers in Pennsylvania, particularly if it were interpreted to apply beyond the narrow facts of that case.**

\* \* \*

(d) Rights of creditors of disclaimant.--Nothing in this section shall determine the effect of a disclaimer upon the rights of creditors of the disclaimant.

**Comment: This provision, although different in mechanics, is intended to adopt the same philosophy as the newly promulgated revision of the Uniform Disclaimer of Property Interests Act, which attempts to leave issues relating to the**

**rights of creditors to statutory provisions and case law expressly directed at that subject. Many of those issues are controversial and in a state of flux. This provision is intended to be entirely neutral as to the impact of disclaimers on the rights of creditors, the impact of bankruptcy, and similar matters. It has been held in Pennsylvania that an insolvent legatee may not freely renounce a gift or legacy because to do so would constitute a fraudulent conveyance, void as to creditors under section 4 of the Uniform Fraudulent Conveyance Act. *Centrella Estate*, 20 D&C.2d 344 (Orphans' Ct. Phila. 1960).**

§ 7104. Power of trustee to resign.

(a) Court approval.--Any trustee may resign with court approval.

(b) Without court approval if authorized by governing instrument.--Any trustee may resign without court approval if authorized to resign by the governing instrument.

(c) When individual trustee may resign without court approval and without authorization in governing instrument.--Unless expressly provided to the contrary in the governing instrument, an individual trustee may resign without court approval and without authorization in the governing instrument if:

(1) consented to in writing by all co-trustees, if there are one or more co-trustees; and

(2) consented to in writing by all the sui juris beneficiaries currently eligible to receive income and by all the sui juris beneficiaries who would receive, if no powers of appointment were exercised, a distribution of principal if the trust were to terminate immediately prior to the resignation,

provided that no such resignation shall be effective unless there is at least one such income beneficiary and at least one such remainderman.

This subsection shall not authorize the sole trustee of a trust to resign unless the governing instrument names a successor trustee or provides a method for appointing a successor trustee, and in either case the resignation shall not be effective until the successor trustee accepts in writing his appointment.

(d) Liability.--The resignation of a trustee shall not by itself relieve the resigning trustee of liability in connection with the administration of the trust.

(e) Definition.--As used in this section the term "sui juris beneficiary" includes a guardian for an incapacitated beneficiary, an agent acting under a durable power of attorney for an incompetent beneficiary and a court-appointed guardian of a minor's estate or, if none, the minor's parents.

**Comment: Subsection (a) states the common law. Subsection (b) reflects the notion that an instrument which authorizes a trustee "to resign" should be interpreted to authorize resignation without court approval. Subsection (c) changes the law, in light of experience that when everyone consents, the expense of obtaining court approval is not justified. The necessity of obtaining the consents is believed to be a sufficient protection.**

**Subsection (c) does not apply to corporate trustees because often the creator of the trust does not want a corporate trustee to be able to resign without court approval regardless of the wishes of the beneficiaries.**

**Subsection (d) is a reminder that a trustee may be released of liability only by judicial approval of an accounting, by releases from the beneficiaries or by such method as may be specified in the trust instrument.**

§ 7105. Filing resignations and appointments.

A resignation of a trustee, an appointment of a trustee and an acceptance of an appointment of a trustee may be filed with the clerk of the orphans' court division having jurisdiction over the trust.

**Comment: This section will enable the clerk of the court to issue more accurate letters of trusteeship.**

TRANSITIONAL PROVISIONS OF  
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(1) The amendments to section 724 shall apply to trusts created before, on or after the effective date of this act.

(2) The amendment to section 2104 shall apply to intestacies occurring on or after the effective date of this act, even if the trust became irrevocable before the effective date of this act.

(3) The amendments to sections 3701 and 3702 shall apply to decedents dying on or after the effective date of this act.

(4) The amendments to section 6205 shall apply to disclaimers made on or after the effective date of this act, and shall apply to disclaimers made before the effective date of this act to the extent the distribution thereunder is made after the effective date of this act or, if made prior to the effective date, such distribution was consistent with this act.

(5) Sections 7104 and 7105 shall apply to trusts created before, on, or after the effective date of this act.

(6) The amendments to sections 724, 2104, 3701, 3702, 5301, 5320, 5321, 6205, 7104 and 7105 shall take effect in 60 days.