



Ninety – Sixth Legislature – First Session – 1999
Introducer's Statement of Intent
LB 63

Chairperson: Senator David M. Landis
Committee: Banking, Commerce, and Insurance
Date of Hearing: February 16, 1999

The following constitutes the reasons for this bill and the purposes which are sought to be accomplished thereby:

LB 63 would enact the Uniform Principal and Income Act (1997) (UPIA 1997) as promulgated by the National Conference of Commissioners on Uniform State Laws. LB 63 would repeal and replace Nebraska's version of the Uniform Principal and Income Act of 1962, as enacted in 1980 (sections 30-3101 to 30-3115).

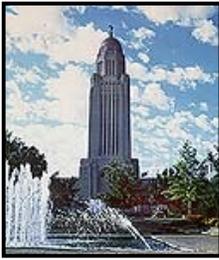
The bill would update the rules which govern a fiduciary in the allocation of receipts and disbursements to or between principal and income. Fiduciaries subject to the bill would be either a trustee of a trust or a personal representative of a decedent's estate.

The bill would provide that a fiduciary shall administer a trust or an estate in accordance with the provisions of UPIA 1997 if the terms of the trust or the will do not contain a different provision or do not give the fiduciary a discretionary power of administration.

Following is a summary of UPIA 1997 taken substantially from materials supplied by the uniform law commissioners.

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

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



Ninety – Sixth Legislature – First Session – 1999 Introducer’s Statement of Intent

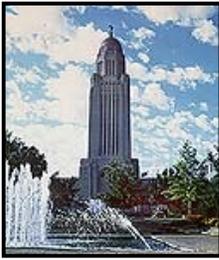
But the identification of principal and income, its allocation, and apportionment of assets between income and principal have always been a very tricky business. Distinguishing income from principal is not always self-evident. Therefore, the law has provided trustees with statutory help for a very long period of time. The Uniform Law Commissioners promulgated the first Uniform Principal Income Act in 1931. A revision was promulgated in 1962. (The 1962 revision was adopted by Nebraska in 1980.) Almost all of the states in the United States have adopted one or the other of these earlier acts by 1997, when a new revision once again was promulgated.

In 1997, 35 years after the 1962 revision, the Uniform Law Commissioners promulgated the Uniform Principal and Income Act (1997) (UPIA 1997). Obsolescence over time was not the only stimulus for promulgating UPIA 1997. In the 1990’s and especially since the promulgation of the Uniform Prudent Investor Act by the Uniform Law Commissioners in 1994, a trustee’s obligation to invest the assets of a trust as a prudent investor would invest them, has substantially altered the fiduciary obligations of a trustee. (The Uniform Prudent Investor Act was adopted by Nebraska in 1997.) There is a strong relationship between the obligation to invest as a prudent investor and the obligation to satisfy income and remainder beneficiaries. The earlier Uniform Principal and Income Acts do not accommodate prudent investor rules. UPIA 1997 does, as will be discussed a little later in this Introducer’s Statement.

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

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

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



Ninety – Sixth Legislature – First Session – 1999
Introducer's Statement of Intent

INITIAL RULE

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

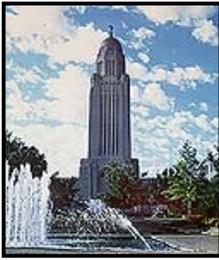
ALLOCATION TO PRINCIPAL OR INCOME

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

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

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

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



Ninety – Sixth Legislature – First Session – 1999
Introducer’s Statement of Intent

APPORTIONMENT ISSUES

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

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

RIGHT TO PAYMENT

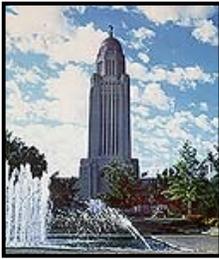
UPIA 1997 expressly requires distribution of net income and principal receipts to the appropriate beneficiaries when a decedent dies or when an income interest ends. There is discretion given to pay certain expenses out of either principal or income unless there is an adverse effect on estate tax marital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

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

ADJUSTMENT POWERS

For Prudent Investment

A trustee must use prudent investment rules in any state that has adopted the Uniform Prudent Investor Act (such as Nebraska), and in any case governed by the Restatement of the Law of Trusts III. The investment policy governing a trust’s assets



Ninety – Sixth Legislature – First Session – 1999
Introducer's Statement of Intent

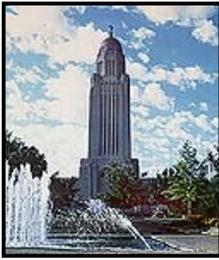
depends upon making the appropriate risk/return analysis and investing accordingly. Asset growth can be as significant an objective as income in setting the investment policy for a specific trust. Because a trustee may weight either growth or income significantly in making investment decisions, and because either may be greater or less than anticipated, the trustee may have to rebalance the interests of remainder and income beneficiaries as a result.

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

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

For Disbursements during the Administration of a Trust

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



Ninety – Sixth Legislature – First Session – 1999
Introducer’s Statement of Intent

During the Conduct of a Business Held in Trust

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

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

For Tax Purposes

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

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

CONCLUSION

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

Principal Introducer:

Senator David M. Landis