WORKING WITH THE PRINCIPAL AND INCOME ACTS IN WASHINGTON AND OREGON

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A. Introduction

Irrevocable trusts, ubiquitous in the estate planning world, are regularly used to hold property for the grantor's spouse, children or other relatives, often because the beneficiary is a minor or is unable for whatever reason to handle money. Historically, many such trusts were drafted to provide all income to the current beneficiary and a remainder interest in the principal to the remainder beneficiaries. Although many such trusts provide the current beneficiary with principal at the discretion of the trustee (e.g., for health, education, maintenance and support), the implicit assumption behind such trusts is that the current beneficiary should be able to live off the income alone. Still other trusts leave the current beneficiary with the right only to the net income ("income trusts").

Whatever the historical reason for this drafting style, income trusts have several problems. First, they do not properly consider the "total return" approach contemplated by modern portfolio theory. By granting the current beneficiary the right to income, the trustee may be tempted to invest trust property primarily with an eye to increasing the amount of trust income generated. This emphasis on income-producing assets may result in a below-average total investment performance, particularly during a time when investments in stocks perform well. Second, as a "one size fits all" style, it does not consider the needs of a given beneficiary. For example, an elderly spouse may require more money from the trust than simply its net income if that spouse needs long-term care.

The rights of the beneficiaries to "income" are determined by the definition of "income," which is found in the Uniform Principal and Income Act (UPIA) [1] of the state in which the trust is administered. Generally, income includes interest, dividends, rents and royalties, but not capital gains, which are a return of principal. This division of returns leads to a conflict between beneficiaries. The income beneficiary would prefer that the trustee invest in income-producing assets (such as bonds), which generally yield little if any growth, while the remainder beneficiary would prefer that the trustee invest in high-growth, low yield assets (such as equities). This conflict is exacerbated by the "total return" approach to investing contemplated by modern portfolio theory and the Uniform Prudent Investor Act.

The best insight into the workings of the UPIA is provided by the comments to the UPIA, drafted by the National Conference of Commissioners on Uniform State Laws (NCCUSL; now the Uniform Law Commission).

The UPIA as adopted in Washington is incorporated in RCW 11.104A; in Oregon, it is incorporated in Chapter 129. These materials will refer both to the relevant section of the UPIA, and to the sections of RCW 11.104A and ORS chapter 129. It also will point out the ways in which the Washington and Oregon statutes vary from the UPIA.

B. General Principles, Duties and Definitions

UPIA §102 (RCW 11.104A.005, ORS §129.205) provides a list of definitions that are necessary for interpreting the balance of the UPIA. The comment to UPIA §102 indicates that the term "income beneficiary" means both mandatory and discretionary beneficiaries; the distinction between the two types of beneficiaries is now irrelevant. Further, the term "inventory value" has been eliminated. [2]

UPIA §103 (RCW 11.104A.010, ORS §129.210) is the most important section in the UPIA. Under UPIA §103, a trustee must allocate receipts and disbursements among principal and income in accordance with the terms of the trust or will, whether or not it creates a result different from that under the UPIA. In other words, an attorney can draft trust or will instruments to avoid the default rules provided under the UPIA. If the terms of the trust or will do not contain provisions different from the UPIA or provide the fiduciary a discretionary power of administration, the default rules under the UPIA are applicable. [3]

[1] (Unif. Law Comm'n 2008). The website of the Uniform Law Commission (http://www.uniformlaws.org) provides the complete acts of the Uniform Principal and Income Act. As of 2016, the only states not to have enacted the UPIA are Georgia, Illinois, Louisiana and Rhode Island.
[2] UPIA §102 cmt. (Unif. Law Comm'n 2008).
[3] See, e.g., French v. Wachovia Bank, N.A., 722 F.3d 1079 (providing example of trust language that displaced default prudent investor rule).

A trustee generally must add receipts and disbursements to principal, unless the terms of the will or trust provide differently or there is a specific rule in the UPIA to the contrary. However, as discussed below, the number of specific rules with respect to the nature of receipts and disbursements are so many that they largely swallow up this general rule. Instead, the drafters of the UPIA provided this rule to cover investments that they could not contemplate. [4]

Under the comment to UPIA §103, a trustee has a duty of impartiality when exercising the power to adjust between principal and income, "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." [5] The comment points out that if the trust terms "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." [6]

Finally, a determination under the UPIA is "presumed to be fair and reasonable to all of the beneficiaries." [7]

C. Trustee's Power to Adjust

Perhaps the most significant change made by the UPIA is the power to adjust. UPIA §104(a) (RCW 11.104A.020, ORS §129.215) provides as follows:

> A trustee may adjust between principal and income to the extent the trustee considers necessary if the trustee invests and manages trust assets as a prudent investor, the terms of the trust describe the amount that may or must be distributed to a beneficiary by referring to the trust's income, and the trustee determines, after applying the rules in [UPIA] §103(a) [RCW 11.104A.020, ORS §129.210], that the trustee is unable to comply with [UPIA] §103(b) [RCW 11.104A.020, ORS §129.210]. [8]

The purpose of this adjustment power 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." [9] The adjustment power is available (subject to other restrictions) if three conditions are met: (1) the trustee is managing trust assets under the prudent investor rule; (2) the trust instrument expresses the current beneficiary's rights in terms of traditional income; and (3) the trustee cannot exercise her duty of impartiality after applying the provisions of the UPIA or the trust or will instrument. [10]

The intent behind this adjustment power is not to "empower a trustee to increase or decrease the degree of beneficial enjoyment to which a beneficiary is entitled." [11] Rather, a trustee may use the adjustment power to compensate for those times when "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." [12] Further, although this adjustment power eliminates the trustee's need to be concerned about the income component of the trust's investment portfolio, the trustee still must "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." [13]

Washington law (RCW 11.104A.020(e)) also allows a personal representative serving with nonintervention powers to adjust.

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[4] UPIA §103 cmt. (Unif. Law Comm'n 2008).
[5] Id.
[6] Id. Note, however, that the comment to UPIA §103 states that "the precise meaning of the trustee's duty of impartiality and the balancing of competing interests and objectives are matters of judgment and interpretations, which is affected by a variety of factors. Id.
[7] UPIA §103(b) (Unif. Law Comm'n 2008).
8 UPIA §104(a) (Unif. Law Comm'n 2008).
9 UPIA §104 cmt. (Unif. Law Comm'n 2008). See Estate of Morse, Index No. 83862 (N.Y. Sur. Ct. 2006) (trustee appropriately exercised power to adjust between income and remainder beneficiaries).
10 Id.
[11] UPIA §104 cmt. (Unif. Law Comm'n 2008). The comment to UPIA §104 states that the first condition of this test is generally satisfied in virtually all states, unless the state provides a statutory list of assets in which a trustee may invest. The second condition is satisfied if the terms of the trust require the trustee (i) to distribute all trust income at regular intervals, (ii) to distribute all trust income among to a class of beneficiaries, the amount of which is left to the discretion of the trustee, or (iii) to distribute to the beneficiary the greater of an annuity amount or a unitrust amount. The third condition is satisfied if the trustee, after determining whether the terms of the trust manifest a clear intention to favor one or more of the beneficiaries, concludes that she is unable to administer the trust impartially or to achieve a degree of partiality required or permitted. Id.
[12] Id. In re Orpheus Trust, 124 Nev. 170, 179 P.3d 562 (2008) (stating that purpose of power to make adjustment "is to permit adjustments between principal and income in order to take advantage of investments which may yield a substantial appreciation of principal value while yielding relatively little income in the conventional sense, or, conversely, an investment which yields a relatively high conventional income might yield a disproportionately low possibility of appreciation principal").
[13] UPIA §104 cmt. (Unif. Law Comm'n 2008).

1. Factors in Determining Whether to Adjust

UPIA §104(b) (RCW 11.104A.020(b), ORS §129.215(2)) provides the following list of factors a trustee must consider when deciding whether to adjust between income and principal:

- the nature, purpose and expected duration of the trust;
- the intent of the settlor;
- the identity and circumstances of the beneficiaries;
- the needs for liquidity, regularity of income and preservation and appreciation of capital;
- the trust assets, and the extent to which the trust assets consist of financial assets, interests in closely held businesses or personal 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 (notice that this last factor contradicts the Prudent Investor Act, which requires the trustee to assess the appropriateness of each asset, whether received from the settlor);
- the net amount allocated to income under other sections of the Act and the increase or decrease in the value of principal;
- the extent to which (if any) the trust allows the trustee to invade principal or accumulate income, and the extent to which the trustee has exercised this power;
- the actual and anticipated effects of economic conditions and inflation or deflation on principal and income; and
- the anticipated tax consequences of an adjustment. [14]

2. Prohibitions on Adjustment Power

Not all trustees can exercise the power to adjust. Under UPIA §104(c) (RCW 11.104A.020(c), ORS §129.215(3)), a trustee may not make an adjustment if:

- the adjustment would disqualify the trust for marital deduction treatment, or that would fail to qualify a trust for the gift tax exclusion;
- the adjustment changes the amount payable to a beneficiary as a fixed annuity or a fraction of trust assets;
- the adjustment is made from any amount that is permanently set aside for charitable purposes under a will or trust unless both income and principal are set aside;
- the adjustment power is the sole reason that the trustee would become the owner of the trust property for income tax purposes;
- holding the adjustment power causes any part of the trust assets to be included in the taxable estate of an individual who has the power to remove or appoint a trustee;
- the trustee is a trust beneficiary; or
- the trustee would benefit, directly or indirectly, from the adjustment. [15]

Washington law (RCW 11.104A.020©(8)) provides an additional prohibition for a trustee who is not a beneficiary, if the adjustment would benefit that trustee directly or indirectly.

Note that these limitations are not entirely clear. For example, the comment to UPIA §104 seems to indicate that UPIA §104(c)(3) governs charitable remainder trusts, including the net-income-with-makeup charitable remainder unitrust, under which the income beneficiary receives the lesser of trust accounting income or the unitrust amount for any given year. This comment suggests that, in certain circumstances, a trustee may be able to adjust income for such trusts. However, UPIA §104(c)(4) states that no adjustment is available for any amounts permanently set aside for charitable purposes. A cautious reading of these two provisions would indicate that an adjustment is not available for net-income-with-makeup charitable remainder unitrusts unless specifically authorized by the terms of the trust. If drafted incorrectly, however, such an adjustment clause could disqualify the trust as a charitable remainder trust under federal tax law.

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[14] UPIA §104(b) (Unif. Law Comm'n 2008).
[15] UPIA §104(c) (Unif. Law Comm'n 2008).

3. Factors to Consider When Using the Adjustment Power

The key element in using the adjustment power is to determine the appropriate level or range of income for the income beneficiary. Once the trustee has determined the range of income, the trustee must determine whether and to what extent to exercise her adjustment power. The UPIA provides the trustee broad discretion in selecting the criteria to determine whether and to what extent to exercise the adjustment power when attempting to achieve impartiality or a predetermined degree of partiality between the beneficiaries. [16]

Once having made the decision to adjust, the trustee must decide how to calculate the amount of adjustment. One method is to analyze the amount of income, on a percentage basis, that would be generated by a balanced investment portfolio. [17] For example, if a hypothetical portfolio built on 50% equities and 50% fixed income would generate 3.2% income, then the trustee can adjust between principal and income in the trustee's actual portfolio so that 3.2% of that actual portfolio is classified as income. This percentage could be calculated using a "floor" and "ceiling" (that is, a fixed percentage range of the prior year's income on the hypothetical portfolio) or a rolling three year average of the return from the hypothetical portfolio. The trustee also would need to determine whether to apply this at the beginning or end of the year. And, of course, the adjustment percentage should be recalculated each year. [18]

Importantly, however, a trustee should remember that the adjustment power is an investment tool, not a technique to benefit one beneficiary over another. This point was made in an Oklahoma case, [19] in which a trustee was found liable for using the adjustment power to increase distributions to the income beneficiary even though the trustee already was investing primarily to generate income rather than long-term growth. In this case, the trust investments, which were primarily invested in municipal bond funds, already favored the income beneficiary over the remainder beneficiary. When the trustee modified the trust's asset allocation to generate more income for the income beneficiary by investing in variable prepaid forward contracts, it effectively used its power to adjust to transfer more income to the income beneficiary, which was a breach of its duty to be impartial. [20]

The following are examples of when a trustee may consider using the adjustment power:

Example: 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 UPIA §406, is a return of capital. In consideration of the loss of value of principal due to inflation and other factors that T deems relevant, T may transfer part of the interest to principal. [21]

Example: 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. T allocates 10% of the distribution to income under UPIA §409(c). 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 UPIA §103(b) include the following: (i) the total return from all of the trust's assets, those owned directly as well as its interest in the IRA; (ii) 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 (iii) the extent to which the income beneficiary will be subject to income tax on the amount that T distributes to the income beneficiary. [22]

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16 UPIA §105 cmt. (Unif. Law Comm'n 2008).
17 Moore & DeHaan, Trustee's Choice: The If, How and When of the UPIA, 153 Trusts & Estates 41, 46 (May 2014).
18 Id. at 46.
19 In re Burford, No. PT 2006-013 (Okla. Dist. Ct. Oct. 9, 2012) (cited in Cohen & Smith, A Trustee's Guide to the Uniform Principal and Income Act, 153 Tr. & Est. 49, 50 (May 2014)).
20 In re Burford, No. PT 2006-013.
21 UPIA §104 cmt. Ex. 2 (Unif. Law Comm'n 2008).
22 UPIA §104 cmt. Ex. 5 (Unif. Law Comm'n 2008).

Example: T is the trustee of a trust whose portfolio includes an interest in a mutual fund 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 UPIA §501(1) and the other one-half from principal under UPIA §502(a)(1). After considering the total return from the portfolio as a whole and other relevant factors described in UPIA §104(b), T may exercise its power to adjust by transferring $1,000, or half of the trust's proportionate share of the fee, from principal to income. [23]

An adjustment may be made at the beginning of an accounting period or retroactively. [24] At least one court has held that the adjustment can be made retroactively for at least a one-year period. [25] No inference of abuse is drawn if a trustee changes the method or criteria for making adjustments. A trustee also may adopt, and thereafter amend, policies that provide criteria or factors to determine when deciding whether and to what extent to use the adjustment power. The policies also may assist the trustee in the event of a lawsuit because the policies provide a manuscript of the trustee's determination to use the adjustment power.

One final, and very important, addition to the Washington statute (RCW 11.104A.02(h)) concerns fiduciary liability when deciding whether to adjust. Unless a beneficiary requests in writing that that fiduciary consider it, the statute imposes no duty on a fiduciary to adjust, and a fiduciary is not liable for not taking it into consideration.

D. Judicial Control of Discretionary Powers

UPIA §105 (RCW 11.104A.030, ORS §129.220) states that the court "may not order a fiduciary to change a decision to exercise or not exercise a discretionary power conferred by this chapter unless it determines that the decision was an abuse of the fiduciary's discretion." [26] Further, a particular decision to exercise or not exercise a discretionary power is not an abuse of discretion "merely because the court would have exercised the power in a different manner or would not have exercised the power." [27] The decisions to which this section applies include (1) a decision as to whether, and to what extent, an amount should have been allocated from income to principal or from principal to income; and (2) a decision regarding the relevant factors to the trust and its beneficiaries, and the extent to which those factors are given weight in determining whether to make an adjustment under UPIA §104. [28]

If a court finds that a trustee abused its fiduciary discretion, the court may restore the beneficiaries and the trust to the positions they would have occupied had the trustee not abused its discretion, in accordance with certain rules that apply, depending upon whether the abuse involved a distribution that was too large or too small. [29] Note, however, that the trustee must pay from its own funds to make the beneficiaries whole only after the court has tried to make the beneficiaries whole from trust assets first.

In Washington, a fiduciary has no liability from its own funds unless the beneficiary alleging the abuse of discretion establishes that the fiduciary did not exercise its discretion in good faith and with honest judgment. The Washington statute (RCW 11.104A.030(e)) also provides that the fiduciary is entitled to reimbursement of fees, costs of defense and liabilities in connection with any claim relating to that fiduciary's exercise of discretion under the Act, unless it is established that that fiduciary did not exercise its discretion in good faith and with honest judgment. Specifically, attorneys' fees and costs shall be advanced to the fiduciary, and shall only be collected from that fiduciary if the fiduciary did not exercise its discretion in good faith and with honest judgment.

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23 UPIA §104 cmt. Ex. 7 (Unif. Law Comm'n 2008).
24 UPIA §105 cmt. (Unif. Law Comm'n).
25 In re Orpheus Trust, 124 Nev. 170, 179 P.3d 562.
26 UPIA §105(a) (Unif. Law Comm'n 2008).
27 Id.
28 UPIA §105(b) (Unif. Law Comm'n 2008).
29 UPIA §105(c) (Unif. Law Comm'n 2008). The comment to UPIA §105 provides for other remedies available if judicial intervention is required. UPIA §105 cmt. (Unif. Law Comm'n 2008).

In a contentious situation, a trustee may not want to make a decision, only to have it challenged as an abuse of discretion later. In this case, UPIA §105(d) (RCW 11.104A.030(d), ORS §129.220(4)) grants the trustee the ability to petition the court for instructions regarding whether a given action is an abuse of discretion. This provision is designed to "provide a fiduciary the opportunity to obtain an assurance of finality in a judicial proceeding" before proceeding with the exercise (or nonexercise) of a discretionary power. [30] It is not intended, however, to "have the court instruct the fiduciary how to exercise the discretion." [31] If the petition describes the proposed exercise or nonexercise of the discretionary power and contains sufficient information to apprise the beneficiaries of the reasons for the proposal, the facts on which the fiduciary relies and an explanation of how the beneficiaries will be affected, then a beneficiary challenging the proposed exercise or nonexercise has the burden of establishing that it results in an abuse of discretion.

E. Decedent's Estate or Terminating Interest

The UPIA provides some additional provisions, more prosaic, that allow for greater clarity in trust administration. UPIA §201 (RCW 11.104A.050, ORS §129.250) describes how income is to be determined and distributed after a decedent dies (in the case of an estate) or after an income interest in a trust ends. First, if an asset has been specifically devised to a beneficiary, the trustee pays net income and net principal receipts attributable to that property as determined under the UPIA. These receipts are determined by including all amounts received or paid with respect to the property, whether due before, on or after the date that triggers the transfer. Further, they are not to be reduced by disbursements from income or principal under UPIA §501(RCW 11.104A.250, ORS §129.400) or §502 (RCW 11.104A.260, ORS §129.405) if the trust, will or applicable law provide that such disbursements are to be made from another source, or to the extent that the fiduciary expects to recover payment from another source.

Second, the trustee determines the remaining net income by applying the UPIA, and then doing the following:

- including in net income all income from property used to discharge liabilities;
- paying from either income or principal, in the fiduciary's discretion, professional fees (attorneys, accountants and fiduciaries), court costs, other administrative expenses and any interest on death taxes (but the fiduciary's discretion is limited in this regard, as discussed below); and
- paying from principal all other disbursements made in connection with either settling the estate or winding up the terminating income interest (including debts, funeral expenses, family allowances and death taxes and related penalties attributable to the estate or terminating interest under either the terms of the document or, if none, applicable law). [32]

Although the fiduciary has the discretion to pay professional fees, court costs and other expenses of administration from either income or principal, the fiduciary may pay only those expenses from income that will not reduce either the estate tax marital and charitable deduction. This provision puts the UPIA in line with the U.S. Supreme Court's decision in the Hubert [33] case and with IRS regulations promulgated in light of that case.

Third, pecuniary gifts are treated separately, and the UPIA is designed to equalize the treatment of lifetime and testamentary gifts. The beneficiary of a pecuniary gift is entitled to as much interest provided under the will, trust or applicable law, to be paid first from net income determined under UPIA §201(2) (RCW 11.104A.050(3), ORS §129.250) and, second, to the extent such income is insufficient, from principal. If the pecuniary gift is made from a trust upon the termination of a terminating interest, then the gift bears interest as though the gift were made under a will.

30 UPIA §105 cmt. (Unif. Law Comm'n 2008).
31 Id.
32 UPIA §201(2) (Unif. Law Comm'n 2008).
33 Commissioner v. Estate of Hubert, 520 U.S. 93 (1997).

Under UPIA §201(4) (RCW 11.104A.050(4), ORS §129.250(4)), the net income distributable to residuary or remainder beneficiaries is to be paid in accordance with the rules in UPIA §202 (RCW 11.104A.060, ORS §129.255), which states that each such beneficiary is entitled to receive a portion of net income equal to the beneficiary's fractional interest in undistributed principal assets, using values as of the date of distribution. If more than one distribution is made, each beneficiary is entitled to a portion of the income not distributed by a subsequent distribution date. The specific rules governing this division of net income are set forth in UPIA §202(b) (RCW 11.104A.060(b), ORS §129.255(2)). The fiduciary must maintain appropriate records if the fiduciary does not distribute all income on a single distribution date.[34] Finally, the fiduciary may, if the fiduciary deems it appropriate, allocate gain and loss among residuary or remainder beneficiaries in the same manner as net income. [35]

F. Apportionment at Beginning and End of Income Interest

UPIA §301 (RCW 11.104A.070, ORS §129.270) defines when income interests begin and end, including when an asset becomes subject to trust. [36] UPIA §302 (RCW 11.104A.080, ORS §129.275) defines the manner in which receipts and disbursements are made if the due date of such receipt or disbursement occurs before the decedent's death, in the case of an estate, or before an income interest begins in the case of a trust. In this case, periodic payments, such as rents, dividends, interest and annuities, or periodic disbursements, such as the interest portion of a mortgage payment, are allocated entirely to principal. The next such payment, however, is allocated without apportionment to income. Non-periodic payments, those that provide no due date for payment (e.g., interest on an income tax refund), also are allocated to principal to the extent they accrue before death or before the income interest begins, unless the obligation is given specifically to a beneficiary. [37]

Finally, UPIA §303 (RCW 11.104A.090, ORS §129.280) addresses the apportionment of "undistributed income," which is income received before the date on which an income interest ends. [38] In general, the income beneficiary who was entitled to the payment, or the estate of that beneficiary if the interest terminates upon death, is entitled to the undistributed income if the interest was a mandatory one, unless the beneficiary had the power to revoke more than 5% of the trust. If the beneficiary did hold such a power, the undistributed income attributable to the revocable portion of the trust is added to principal. Additionally, if a beneficiary may withdraw the principal, in part or in whole, after attaining a specified age and the beneficiary attains such age but does not withdraw the principal amount, a trustee is not required to pay the beneficiary or her estate the undistributed income attributable to the principal amount she left in trust. [39]

G. Allocation of Receipts During Trust Administration

One of the great benefits of the adoption of the UPIA is the number of provisions relating to the specific allocation to either income or principal of several types of receipts not previously accounted for.

1. Character of Receipts from Entities

In general, UPIA §401(b) (RCW 11.104A.100(b), ORS §129.300(2)) states that "a trustee shall allocate to income money received from an entity." [40] Under UPIA §401(a) (RCW 11.104A.100(a), ORS §129.300(1)), an "entity" is defined as a corporation, partnership, limited liability company, regulated investment company, real estate investment trust (REIT), common trust fund or any other organization in which the trustee has an interest, other than trusts, estates, business activities governed by UPIA §403 (RCW 11.104A.120, ORS §129.308) or asset-backed securities governed by UPIA §415 (RCW 11.104A.240, ORS §129.385).

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[34] UPIA §202(c) (Unif. Law Comm'n 2008).
[35] UPIA §202(d) (Unif. Law Comm'n 2008).
[36] UPIA §301 (Unif. Law Comm'n 2008) (income interest generally begins on date specified in trust or, if no date is specified, on date assets become subject to trust or successive income interest; income interest generally ends on day before income beneficiary dies or another termination event occurs or on last day of period during which no income beneficiary exists).
[37] UPIA §302 cmt. (Unif. Law Comm'n 2008).
[38] UPIA §303 (Unif. Law Comm'n 2008) (term "undistributed income" does not include (i) items of income or expense that are due or accrued, or (ii) net income that has been added or is required to be added to principal under terms of trust).
[39] UPIA §303 cmt. (Unif. Law Comm'n 2008).
[40] UPIA §401(b) (Unif. Law Comm'n 2008).

There are, however, important exceptions to this general rule. A trustee shall allocate to principal the following receipts from an entity:

- property other than money;
- money received in one or more distributions in exchange for part of all of the trustee's interest in the entity;
- money received in total or partial liquidation of the entity; and
- money received from an entity that is a regulated investment company or REIT if the money distributed is a capital gain dividend for federal income tax purposes. [41]

In other words, cash distributions from an entity to a trustee are assumed to be income, unless it can be proven that the distribution is a return of principal, either in the form of property other than money, distributions in redemption or liquidation of interests and capital gain distributions.

Under UPIA §401(d) (RCW 11.104A.100(d), ORS §129.300(4)), money is received in partial liquidation either to the extent that the entity indicates that it is a distribution in partial liquidation or if the total amount of money and other property received in one or more distributions is greater than 20% of the entity's gross assets. This 20% test must be indicated on the entity's year-end financial statements immediately preceding initial receipt of property. However, UPIA §401(e) (ORS §129.300(5)) points out that money is not received in partial liquidation 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. In other words, "[i]n 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 beneficiary must pay on the entity's taxable income is ignored." [42]

The comment to UPIA §401 also takes into account the effects of large distributions. For example, a distribution greater than 10% but not more than 20% of the entity's assets may "have characteristics that suggest it should be treated as principal rather than income." [43] If the entity sold an investment asset or a business asset other than one held for sale to customers in the normal course of business or borrowed a large sum of money, securing it with a loan against principal, or finally had a principal source of cash from an asset like mineral interests, "90% of which would have been allocated to principal if the trust had owned the asset directly," then in this case the trustee "may decide to exercise the power to make an adjustment between income and principal," subject to any limitations in the UPIA. [44]

Finally, a trustee may rely on the statement of an entity about the source or character of a distribution if the statement is made on or near the date of distribution and is made by the board of directors, or persons with equivalent authority. [45]

2. Distributions from Trusts or Estates

Distributions from trusts or estates are dealt with in UPIA §402 (RCW 11.104A.110, ORS §129.305). Three factors should be considered when allocating such distributions between income or principal: (1) the character of the distribution as defined under the distributing trust; (2) the character of the distribution as it is received by the recipient trust; and (3) the definition of the distribution under the UPIA.

These three factors can lead to conflicts (for example, when they direct that the distribution, even though made from the income of the distributing trust or estate, is to be added to the principal of the recipient trust). 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. [46]

Distributions from trusts that are investment entities, such as real estate investment trust (REITs), are characterized either under UPIA §401 (RCW 11.104A.100, ORS §129.300) or UPIA §415 (RCW 11.104A.240, ORS §129.385), which deals with asset-backed securities.

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[41] UPIA §401(c) (Unif. Law Comm'n 2008).
[42] UPIA §401 cmt. (Unif. Law Comm'n 2008).
[43] Id.
[43] Id.
[45] UPIA §401(f) (Unif. Law Comm'n 2008).
[46] UPIA §402 cmt. (Unif. Law Comm'n 2008).

3. Business and Other Activities Conducted by the Trustee

Some trustees may choose to operate a business as a proprietorship rather than in entity form. UPIA §403(b) (RCW 11.104A.120(b), ORS §129.308(2)) allows the trustee who accounts separately for a business or other activity to determine the extent to which 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. The trustee may conduct this separate accounting if the trustee determines that it is in the best interest of all the beneficiaries. If the trustee maintains a separate accounting, the trustee may also determine the extent to which the remaining net cash receipts are accounted for as principal or income in the trust's general accounting records. The trustee may maintain separate accounting records for these business transactions whether those assets are segregated from other trust assets.

Washington law (RCW 11.104A.120(a)) imposes the additional requirement that a trustee must maintain those records in accordance with generally-accepted accounting principles.

The following activities are those for which a trustee may maintain separate accounting records:

- retail, manufacturing, and service industries;
- other traditional business activities;
- farming;
- raising and selling livestock;
- managing rental properties;
- mineral, timber and other natural resource operations; and
- certain derivative and option transactions. [47]

Note, however, that this section is not intended "to permit a trustee to account separately for a traditional securities portfolio to avoid the provisions of [the UPIA] that apply to such securities." [48]

The proceeds received from liquidating a sole proprietorship or other activity under UPIA §403 (RCW 11.104A.120, ORS §129.308) must be added to principal because it is no longer required in the conduct of the business. This includes liquidations that occur during probate or during an income interest's winding up period. [49]

4. Principal Receipts

Under UPIA §404 (RCW 11.104A.130, ORS §129.310), the following miscellaneous items are allocated to principal:

- to the extent that not allocated to income under another part of the UPIA, assets received from a transferor (typically by gift), from a decedent's estate, from a trust with a terminating income interest (e.g., where the recipient trust is a remainder beneficiary of the distributing trust), or by the recipient trust as a payer under a contract naming the trust or its trustee as a beneficiary;
- property, including money, received from the sale, exchange, liquidation or change in form of a principal asset (including realized profit), but subject to the other provisions of Article 4 of the UPIA (RCW 11.104A.170-240, ORS §129.300-385);
- money received from third parties in reimbursement for trust distributions relating to environmental matters under UPIA §502(a)(7) (RCW 11.104A.260(a)(7), ORS §129.405(1)(g));
- proceeds of property taken by eminent domain is principal, except for separate awards made for the loss of income during an accounting period in which a current income beneficiary had a mandatory income interest, which is allocated to income;
- net income received in an accounting period during which there is no beneficiary to whom a trustee may or must distribute income is deemed principal; and
- receipts that are stated specifically in UPIA §408–§415A (RCW 11.104A.170-240, ORS §129.350-385). [50]

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[47] UPIA §403(c) (Unif. Law Comm'n 2008).
[48] UPIA §403 cmt. (Unif. Law Comm'n 2008).
[49] UPIA §404 cmt. (Unif. Law Comm'n 2008).
[50] UPIA §404 (Unif. Law Comm'n 2008).

5. Rental Property

Receipts from rental property that are not separately accounted for under UPIA §403 (RCW 11.104A.120, ORS §129.308) are addressed by UPIA §405 (RCW 11.104A.140, ORS §129.315), which provides that the trustee shall allocate to income an amount received as rent of real or personal property, including an amount received for cancellation or renewal of a lease. However, amounts received as a refundable deposit, including security deposits or deposits to be applied as rent for future periods, must be added to principal and held subject to the terms of the lease. [51] This property is not available for distribution to a beneficiary until the trustee's contractual obligations have been satisfied with respect to that amount. "If the trustee is accounting for rental income under UPIA §405, a transfer from income to reimburse principal may be appropriate under [UPIA] §504 to the extent that some of the 'rent' is really a reimbursement for improvements." [52]

6. Obligation to Pay Money

For interest received on an obligation to pay money, a trustee must allocate the interest to trust income without any provision for amortization of premium. [53] For purposes of UPIA §406 (RCW 11.104A.150, ORS §129.320), the term "interest" includes amounts received as consideration for prepayment of principal. Note that, even though an obligation's interest rate may change from time to time (e.g., as a result of changes in a market indicator), the obligation is subject to UPIA §406 and not to UPIA §414 (dealing with derivatives and options). [54]

There are two exceptions to this general rule. First, amounts received from sale, redemption or other disposition of an obligation are allocated to principal if the sale or disposition occurs more than one year after it is purchased or acquired by the trustee. This includes obligations whose "purchase price or value when … acquired is less than its value at maturity." [55] However, if the trustee purchases or acquires an obligation that matures within one year, the trustee must allocate to income any amount in excess of the obligation's purchase price or value when acquired. [56]

Under the comment to UPIA §406, this first exception 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 bond, and discount bonds that pay interest during part, but not all, of the period before maturity." [57] The entire increase in value of such obligations is principal when the trustee receives the proceeds of sale, unless the obligation, when acquired, has a maturity of less than one year. [58] Further, all of the increase in principal of an inflation-indexed bond that is attributable to inflation is attributable to principal, unless the obligation matures within one year, in which case it is attributable to income.

The second exception to this general rule carves out obligations to which UPIA §409, §410, §411, §412, §414 or §415 (RCW 11.104A.180-210 or 11.104A.230-240, or ORS §129.355, 129.360, 129.365, 129.370, 129.380 or 129.385) apply. [59]

The comment also points out that, when a trustee is deciding whether to adjust between principal and income, a relevant factor is the effect on the portfolio as a whole of having some portion of the assets invested in bonds that pay no current income. [60]

7. Insurance and Similar Contracts

The general rule under UPIA §407 (RCW 11.104A.160, ORS §129.325) provides that a trustee must allocate the proceeds of a life insurance policy or other contract in which the trust or trustee is the beneficiary to principal. This includes contracts insuring the trust against loss for damage to, destruction of or loss of title to a trust asset. A trustee must allocate dividends on an insurance policy to income if the premiums are paid from income and to principal if the premiums are paid from principal. There is an exception to this general rule: proceeds of a contract that insure the trustee against loss of occupancy or other use by an income beneficiary, loss of income or loss of profits from a business are allocated to income. [61] Further, these provisions do not apply to contracts to which UPIA §409 (RCW 11.104A.180, ORS §129.355) applies. [62]

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51 UPIA §405 (Unif. Law Comm'n 2008).
52 UPIA §405 cmt. (Unif. Law Comm'n 2008).
53 UPIA §406(a) (Unif. Law Comm'n 2008).
54 UPIA §406 cmt. (Unif. Law Comm'n 2008).
55 UPIA §406(b) (Unif. Law Comm'n 2008).
56 Id.
57 UPIA §406 cmt. (Unif. Law Comm'n 2008).
58 Id.
59 UPIA §406(c) (Unif. Law Comm'n 2008).
60 UPIA §406 cmt. (Unif. Law Comm'n 2008).
61 UPIA §407(b) (Unif. Law Comm'n 2008).
62 UPIA §407(c) (Unif. Law Comm'n 2008).

8. Insubstantial Allocations

A trustee does not have to make relatively small allocations between principal and income, even though the trustee's right to do so is preserved if an allocation is large in terms of absolute dollars. Under UPIA §408 (RCW 11.104A.170, ORS §129.350), an allocation is presumed to be insubstantial if either (1) the amount of the allocation would increase or decrease net income in a single accounting period, as determined before the allocation, by less than 10%; or (2) the value of the asset producing the receipt to be allocated is less than 10% of the total value of the trust's assets. The entire amount of an insubstantial receipt should be allocated to principal. [63]

9. Deferred Compensation, Annuities and Similar Payments

UPIA §409 (RCW 11.104A.180, ORS §129.355) deals with several different types of payments made over a fixed number of years or during the life of one or more individuals as a result of either services rendered or property transferred in exchange for future payments. [64] To the extent that such a payment is characterized as interest or a dividend (or a payment made in lieu of an interest or a dividend), it is allocated to income. [65] The balance of the payment is allocated to principal. If no part of a payment is characterized as interest, dividend or an equivalent, and all or part of the payment must be made, a trustee allocates to income 10% of the payment that must be made. Under RCW 11.104A.180(c), Washington does not follow this "10% of payment" rule, but instead mandates a distribution of 4% of the assets in the plan or annuity. If no part of the payment must be made or the payment received is the entire amount to which the trustee is entitled, then the trustee must allocate the entire payment to principal. [66] Washington law does not contain this specific allocation.

There are two exceptions to this general rule. First, UPIA §409(f) and §409(g) (RCW 11.104A.180(f) and (g), ORS §§129.355(6) and (7)), which are discussed in greater detail below, apply to allocations of a payment made from a separate fund to a trust that qualified for the marital deduction under §2056(b)(5) or §2056(b)(7). [67] UPIA §409(f) applies if the trustee can determine the internal income of a separate fund; whereas, UPIA §409(g) applies if the trustee cannot determine either the internal income of a separate fund or the fund's value or both, which is generally due to a lack of information. Second, this section does not apply to liquidating assets described in UPIA §410. [68]

UPIA §409 is important because it applies to IRAs, deferred compensation plans, retirement plans, variable annuities, deferred annuities, annuities issued by commercial insurance companies and private annuities. [69] Note that IRAs and arrangements with payment provisions similar to IRAs are considered payments no part of which are characterized as interest, dividend or an equivalent; therefore, 10% of any IRA distribution is allocated to income. For example, 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 IRS may require them to be taken into account for estate tax marital deduction purposes). [70] This 10% allocation to income applies only to payments that are required to be made, which includes payments of "required minimum distributions" under §401(a)(9). On the other hand, if the trustee voluntarily withdrew all of the funds from an IRA, the entire withdrawal is allocated to principal. Thus, absent a specific term in the trust agreement, the trustee cannot increase the amount of IRA property that is distributable to an income beneficiary simply by accelerating the rate of withdrawal above the required minimum distribution rate. Instead, the trustee must rely on the ability to make adjustments, described earlier.

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63 UPIA §408 (Unif. Law Comm'n 2008).
64 UPIA §409(a) (Unif. Law Comm'n 2008) (defining "payment" and "separate fund").
65 UPIA §409(b) (Unif. Law Comm'n 2008).
66 UPIA §409(c) (Unif. Law Comm'n 2008).
67 UPIA §409(d) (amended by the National Conference of Commissioners on Uniform State Laws (NCCUSL) in 2008).
68 UPIA §409(h).
69 UPIA §409, cmt.
70 Id.

Revenue Ruling 2006-26 [71] addresses three different factual situations involving the potential application of UPIA §409 when a "marital trust" (the ruling's term for a QTIP trust) is named as the beneficiary of the decedent's "IRA or other defined contribution plan." The factual background for each of the three situations is the same: Decedent dies in 2004 at age 68, survived by Spouse. Decedent previously established an IRA, which names a testamentary marital trust (Trust) created under Decedent's will as the beneficiary. The IRA is invested in productive assets, and Spouse has the right to compel the IRA to invest in productive assets. The IRA plan document allows withdrawals from the IRA in excess of the required minimum distribution under §408(a)(6). The executor of the Decedent's estate elects to treat both the IRA and the Trust as QTIP under §2056(b)(7). The Trust provides that all income is payable annually to Spouse for Spouse's lifetime, and no one has the power to appoint property to someone other than Spouse during Spouse's lifetime. Finally, as provided in Rev. Rul. 2000-2, the Spouse has the annual right to compel the trustee to distribute all of the IRA income for that year to Spouse.

In Situation 1, the Trust is administered in State X, which has adopted a version of the UPIA that includes a provision similar to UPIA §104(a), which allows for adjustments between income and principal. State X also incorporates (1) a provision similar to UPIA §409(c), under which 10% of an IRA distribution to a trustee is allocated to income and 90% to principal, and (2) a provision similar to UPIA §409(d) (before the 2008 amendment), under which the trustee must allocate to income an additional amount of an IRA distribution necessary to qualify for the estate tax marital deduction. For each year, the trustee determines the total return of the Trust assets, determines the respective portions of that return that should be allocated to income and principal and then makes that allocation "without regard to, and independent of, the trustee's determination with respect to Trust income and principal."

In Situation 2, the Trust is administered in State Y, the laws of which allow a trustee to convert an "all income" trust to a 4% unitrust, and distribute to the beneficiary 4% of the fair market value of the trust assets in each year, rather than trust income. With the consent of all interested parties, the trustee makes the conversion. Also, if Spouse exercises the withdrawal power, the trustee withdraws from the IRA the greater of the required minimum distribution or an amount equal to 4% of the value of the IRA assets, and distributes to Spouse at least an amount equal to 4% of that value.

In Situation 3, the Trust is administered in State Z, which has not enacted the UPIA and, therefore, does not have provisions similar to UPIA §104 or §409 (nor, by implication, does it include the power to convert the trust to a 4% unitrust). As a result, in determining the amount that Spouse can compel the trustee to withdraw from the IRA, the trustee looks only to the State Z principal and income law, and the income of the IRA is separately determined based on IRA assets.

In Situation 1, the IRS ruled that the Trust qualifies for QTIP treatment because the trustee is allocating the total return of the Trust under state law in a manner that satisfies the trustee's duty of impartiality and the allocation constitutes a reasonable apportionment of total return under Reg. §1.643(b)-1 and §20.2056(b)-5(f)(1) and . However (and most importantly), the IRS went on to rule that, depending upon the terms of the Trust, the provisions of UPIA §409(c) and §409(d) may have to be considered. The 10% allocation of the IRA required minimum distribution, standing alone, does not satisfy the requirements of §1.643(b)-1 and §20.2056(b)-5(f)(1) because the amount of the required minimum distribution is not based on the total return of the IRA; therefore, the amount allocated to income does not reflect a reasonable apportionment of the total return between the income and remainder beneficiaries. Because the apportionment is not reasonable, the Trust does not qualify for QTIP treatment. Further, the IRS ruled that the provisions of pre-2008 UPIA §409(d), which require an additional allocation to income if it is necessary to qualify for the estate tax marital deduction, were the equivalent of a "savings clause," and were "ineffective to reform an instrument for federal transfer tax purposes." [72] Therefore, the IRS concluded, if the terms of a trust under the facts in Situation 1 do not require the distribution to Spouse of at least the income of the IRA in the event Spouse exercises the right to direct an IRA withdrawal, then that trust will not qualify for QTIP treatment unless the trust agreement overrides the 10%/90% allocation provisions under UPIA §409(c).

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[71] 2006-22 I.R.B. 939 (modifying and superseding Rev. Rul. 2000-2, 2000-1 C.B. 305).

[72] Rev. Rul. 2006-26 (citing Rev. Rul. 75-440, 1975-2 C.B. 372 and modifying and superseding Rev. Rul. 2000-2, 2006-22 I.R.B. 939).

The IRS went on to rule that the Trust under Situations 2 and 3 would qualify for QTIP treatment because Spouse had the right to compel a distribution from the Trust of at least all of the income of the IRA, and that income was determined under either a 4% of fair market value or (impliedly) a state law that does not adopt a "savings clause" type approach.

> Practice Point: Although the ruling is, in this author's view, incorrectly decided, it makes very clear that all QTIP trusts holding IRAs or other defined contribution plans as assets must include the language allowing the surviving spouse to require the trustee to withdraw all income from the plan and distribute it to the spouse. This begs the question of how the trustee is to determine what constitutes income, particularly in 401(k) plans that are managed by an employer.

The Uniform Law Commission amended UPIA §409(d) in 2008 to take into account Rev. Rul. 2006-26. The revised comment to UPIA §409 notes that the 2008 amendments are designed to satisfy the IRS's safe harbor regarding the surviving spouse's rights to demand income (as described in Rev. Rul. 2006-26) and address concerns that might be raised for assets similar to the IRAs and defined contribution retirement plans addressed in Rev. Rul. 2006-26. As amended, UPIA §409(d) specifies that, in determining the allocation of a payment made from a separate fund to a trust that qualifies for an estate tax marital deduction under §2056(b)(5) (power of appointment) or §2056(b)(7) (QTIP), UPIA §409(f) and §409(g) apply and UPIA §409(b) and §409(c) do not apply. [73]

Under UPIA §409(f), the trustee determines the amount of income of each separate fund for an accounting period as if the separate fund were a trust subject to the UPIA. If the surviving spouse requests, the trustee must demand that the separate fund's administrator distribute the fund's internal income to the trust. The trustee must allocate a payment from the separate fund to income to the extent of the fund's internal income and distribute that amount to the spouse. [74] The trustee must allocate the balance to principal. [75] If the surviving spouse requests, the trustee must allocate principal to income to the extent the separate fund's internal income exceeds payments made from the fund to the trust during the accounting period. [76]

Under UPIA §409(g), if the trustee cannot determine the separate fund's internal income but can determine the fund's value, the fund's internal income is deemed to equal a percentage (at least 3% but not more than 5%) of such value. [77] To determine the value of the separate fund, the trustee uses the most recent statement of value preceding the start of the accounting period. If the trustee cannot determine the separate fund's internal income or value, the fund's internal income is deemed to equal the product of the interest rate and the present value of the expected future payments (as determined under §7520) for the month preceding the accounting period for which the computation is made. [78]

Oregon's version of this section includes one provision that isn't in UPIA §409. Under ORS§129.355(8), an increase in value in certain assets over their value at the time of contribution to the trust is treated wholly as income. These assets include zero-coupon bonds, deferred annuity contracts surrendered before annuitization or life insurance contracts surrendered before the death of the insured. Note, however, that the increase in value from those assets can be distributed only when the trustee receives cash on account of those assets. Once the asset is wholly or partially surrendered or liquidated, the cash proceeds are attributed first to post-contribution increase (and therefore distributable currently as income).

This little-used provision allows a trustee to invest in a deferred annuity or life insurance contract, grow the underlying asset in value, characterize all that growth as income, and "time" the distribution of that income by wholly or partially surrendering the asset at an appropriate time. In the meantime, so long as such investments are held in annuity or insurance form, the trustee will have no taxable income from them.

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73 However, UPIA §409(d), §409(f), and §409(g) do not apply if and to the extent that the series of payments would, without the application of UPIA §409(d), qualify for the marital deduction under §2056(b)(7)(C) (survivor annuities). UPIA §409(d), §409(e) (Unif. Law Comm'n 2008).
74 UPIA §409(f) (Unif. Law Comm'n 2008).
75 Id.
76 Id.
77 UPIA §409(g) (Unif. Law Comm'n 2008). The revised comment to UPIA §409 notes that this is the range approved for unitrust payments under Reg. §1.643(b)-1 (discussed at VIII., below).
78 UPIA §409(g) (Unif. Law Comm'n 2008).

10. Liquidating Assets

UPIA §410 (RCW 11.104A.190, ORS §129.360) defines the term "liquidating asset" as one "whose value will diminish or terminate because the asset is expected to produce receipts for a period of limited duration." [79] A trustee must allocate 10% of the receipts from a liquidating asset to income and the balance to principal. Interestingly, the reference 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. [80]

11. Minerals, Water and Other Natural Resources

UPIA §411 (RCW 11.104A.200, ORS §129.365), dealing with minerals, water and other natural resources (other than timber), provides a somewhat complex allocation scheme. As a general rule, 10% of receipts from an interest in minerals or other natural resources is allocated to income and 90% is allocated to principal. However, the following payments receive special treatment: (1) nominal delay rentals and nominal annual rent on a lease are allocated to income; (2) production payment receipts are allocated to income to the extent that the agreement creating the production payment provides a factor for interest or its equivalent and the balance is allocated to principal; (3) amounts received as royalty, shut-in-well payments, take-or-pay payments, bonus or delay rental are allocated 10% to income and 90% to principal if the payment is more than nominal. [81] Additionally, receipts from an interest in water is allocated to income if the water is renewable; otherwise, 90% of receipts is allocated to principal and the balance is allocated to income. [82] Note that this section applies whether a decedent or donor was extracting the resources before the interest became subject to the trust. [83]

There is an exception for trustees that own an interest in natural resources on the effective date of the UPIA. In this case, the trustee may allocate receipts from the interest as provided in the UPIA or in the manner used by the trustee before the effective date of the UPIA. [84]

12. Timber

Proceeds from timber are addressed under UPIA §412 (RCW 11.104A.210, ORS §129.370). To the extent that a trustee accounts for receipts from the sale of timber and related products, the trustee allocates the net receipts as follows:

- 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;
- to principal to the extent that the amount of timber removed from the land exceeds the rate of growth of the timber;
- to or between income and principal if the net receipts are from the lease of timber or from a cutting contract from land owned by the trustee, by determining the amount of timber removed from the land under the lease or contract and applying the first two rules; or
- to principal to the extent that advance payments, bonuses and other payments are not allocated in the manner just described. [85]

There are three caveats to this general rule. First, in determining net receipts to be allocated, a trustee must deduct and transfer to principal a reasonable amount for depletion. [86] Second, the UPIA applies whether the decedent or transferor was harvesting timber from the property before it became subject to the trust. [87] Finally, as with natural resources, a trustee who owns the timber interests before the effective date of the UPIA may allocate net receipts either in accordance with the UPIA or in accordance with the method the trustee was using before the effective date of the UPIA. [88]

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[79] UPIA §410(a) (Unif. Law Comm'n 2008) (term "liquidating assets" include leaseholds, patents, copyrights, royalty rights and rights to receive payments during period for more than one year under arrangement that does not provide for payment of interest on unpaid balance; however, liquidating assets do not include payments under UPIA §409 (deferred compensation, etc.), §411 (natural resources), §412 (timber), §414 (derivatives and options), §415 (asset-backed securities) or for any asset for which trustee establishes depreciation reserve under UPIA §503).
[80] UPIA §410 cmt. (Unif. Law Comm'n 2008).
[81] UPIA §411(a) (Unif. Law Comm'n 2008).
[82] UPIA §411(b) (Unif. Law Comm'n 2008).
[83] UPIA §411(c) (Unif. Law Comm'n 2008).
[84] UPIA §411(d) (Unif. Law Comm'n 2008).
[85] UPIA §412(a) (Unif. Law Comm'n 2008).
[86] UPIA §412(b) (Unif. Law Comm'n 2008).
[87] UPIA §412(c) (Unif. Law Comm'n 2008).
[88] UPIA §412(d) (Unif. Law Comm'n 2008).

The comment to UPIA §412 provides that this section is intended to apply to net receipts from the sale of "trees and byproducts 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." [89] Additionally, UPIA §412 applies to the sales of trees that are expected to produce building lumber, trees sold as pulp wood and Christmas or other ornamental trees. This section applies only to the extent that the trustee does not account separately for the net receipts or allocates all of the receipts to principal under the rules previously described. [90]

13. Unproductive Property

UPIA §413 (RCW 11.104A.220, ORS §129.375) represents a significant change from prior law. With the exception of property subject to a marital deduction, 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. [91] However, in the case of property for which a marital deduction is allowed that does not provide the spouse with sufficient income from or use of the trust assets, the spouse may require the trustee to make property productive of income, convert property within a reasonable time or exercise the adjustment power. The decision of which of these to take is in the hands of the trustee. [92]

Previous UPIAs gave to an income beneficiary the right to receive a portion of the proceeds from the sale of underproductive property as "delayed income." This analysis applied on an asset by asset basis and not by taking into consideration the trust portfolio as a whole. This conflicted with the basic precepts of the Prudent Investor Act. [93] To implement the Prudent Investor Act, the UPIA abolishes the right to receive delayed income from the sale proceeds of an asset that produces no income. [94]

14. Derivatives and Options

UPIA §414 (RCW 11.104A.230, ORS §129.380) deals with the difficult concept of "derivatives." [95] To the extent that the trustee does not allocate receipts from derivatives under UPIA §403 (dealing with business and other activities conducted by the trustee), the trustee shall allocate to principal receipts from and disbursements made in connection with derivative transactions. [96]

With respect to options, if a trustee grants an option to buy property from the trust whether the trustee owns the property when the option is granted, amounts received for granting the option must be allocated to principal. Any amounts paid to acquire options must be paid from principal. Finally, gain or loss realized upon the exercise of an option including an option granted to a settler of the trust for services rendered, also are allocated to principal. [97]

15. Asset-Backed Securities

Typically, asset-backed securities, as defined in UPIA §415 (RCW 11.104A.240, ORS §129.385), 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 trusts are sold to investors. [98] The source for payments to the investor is money received from principal and interest payments on the underlying debts.

The trustee allocates to income the portion of a payment from these assets "which the payer identifies as being from interest or other current return" and allocates the balance of the payment to principal. [99] If the trustee receives one or more payments in exchange for the trust's entire interest in an asset-backed security in one accounting period, then the trustee allocates the payments to principal. [100] On the other hand, if the payment is one of a series of payments that results in the liquidation of the interest in the security over more than one accounting period, then the trustee allocates 10% of the payment to income and the balance to principal.

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89 UPIA §412 cmt. (Unif. Law Comm'n 2008).
90 UPIA §412 cmt. (Unif. Law Comm'n 2008).
91 UPIA §413(b) (Unif. Law Comm'n 2008).
92 UPIA §413(a) (Unif. Law Comm'n 2008).
93 UPIA §413 cmt. (Unif. Law Comm'n 2008).
94 Id.
95 UPIA §414 cmt. (Unif. Law. Comm'n 2008) (term "derivatives" defined as contracts or financial instruments (or combination of both) which give trustee right or obligation to participate in some or all changes in price of tangible or intangible assets or groups of assets, or changes in rates, index of prices or rates or other market indicator for assets or groups of assets; derivatives often include futures, forwards, swaps, options and similar instruments).
96 UPIA §414(b) (Unif. Law Comm'n 2008).
97 UPIA §414(c) (Unif. Law Comm'n 2008). For further discussion of the definition of derivatives, including gain or loss that occurs as a result of "marketing to market," see UPIA §414 cmt.
98 UPIA §415(a) (defining "asset-backed security" as (1) assets whose value is based upon the right they give the owner to receive distributions from the proceeds of financial assets that provide collateral for the security, and (2) assets that give 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; asset-backed securities often include arrangements in which debt obligations such as real estate mortgages, credit card receivables and auto loans are sold to investors).
99 UPIA §415(b) (Unif. Law Comm'n 2008).
100 UPIA §415(c) (Unif. Law Comm'n 2008).

H. Allocation of Disbursements During Trust Administration

1. Disbursements from Income or Principal

Article 5 of the UPIA sets forth the rules for making disbursements from either principal or income. Under UPIA §501 (RCW 11.104A.250, ORS §129.400) and §502 (RCW 11.104A.260, ORS §129.405), payments of trustee compensation, as well as investment, advisory or custodial services, are paid half from income and half from principal. [101] The same is true for expenses for accountings, judicial proceedings and other matters involving both the income and remainder interests. [102] On the other hand, all ordinary expenses incurred in connection with the administration of the trust (including interest, ordinary repairs, regularly recurring taxes) are paid solely from income, while disbursements related to environmental matters, estate and inheritance taxes and payments of principal on trust debts are payable from principal. [103]

The comments to Article 5 of the UPIA discuss environmental expenses at some length. They note that such expenses are usually assumed to be "extraordinary in nature" and, therefore, payable from principal. However, such expenses could be payable from income if the trustee "is carrying on a business that uses or sells toxic substances." In this case, environmental cleanup costs would be a normal cost of doing business and would be accounted for under UPIA §403 (dealing with business and other activities conducted by the trustee). [104]

Oregon law (ORS §129.400(2)) allows a trustee, using reasonable judgment, to charge all or part of the trustee or investment advisory fees to either principal or income, if the normal "50/50" allocation is impracticable because of lack of sufficient cash or readily marketable securities.

2. Adjustments for Depreciation and Taxes

UPIA §503 (RCW 11.104A.270, ORS §129.410) gives the trustee the power to transfer to principal a reasonable amount of cash receipts from a principal asset that is subject to depreciation, with the exception of amounts for depreciation attributable to real property used by a beneficiary as a residence, incurred during the administration of an estate or any other depreciation if the trustee is accounting under UPIA §403 (RCW 11.104A.120, ORS §129.308) for the business for which the asset is being used. Washington law (RCW 11.104A.270) does not provide the prohibition against a transfer for depreciation during the administration of a decedent's estate.

UPIA §504 (RCW 11.104A.280, ORS §129.415) deals with reimbursements from income to principal for expenses paid from principal, such as extraordinarily large repairs, capital improvements, and disbursements made to prepare property for rental.

Finally, UPIA §505 (RCW 11.104A.290, ORS §129.420) and §506 (RCW 11.104A.300, ORS §129.425) deal with income taxes and adjustments to be made between income and principal as a result of payment of those taxes, respectively. The comments to UPIA §505 and §506 discuss payment of taxes passed through from an entity, such as a partnership, and adjusting between income and principal for certain elections the fiduciary makes relating to taxes.

101 UPIA §501(1), §502(a)(1) (Unif. Law Comm'n 2008).
102 UPIA §§501(2), §502(a)(1) (Unif. Law Comm'n 2008).
103 UPIA §501(3), §502(a)(6), §502(a)(7) (Unif. Law Comm'n 2008).
104 UPIA §502 cmt. (Unif. Law Comm'n 2008).

I. Conversion to Unitrust

One of the most significant developments in the area of principal and income acts is not a feature of the UPIA. Both Washington and Oregon include in their principal and income acts (RCW 11.104A.040, ORS §129.225) the power of a trustee to release the power to make adjustments between principal and income and instead convert the trust to a unitrust (indeed, the two statutes look similar, as the Oregon statute was based in large part on the Washington statute). Following such a conversion, the trustee continues to make regular distributions under the terms of the trust; however, all provisions relating to distribution of income are instead construed to refer to an annual unitrust distribution equal to a percentage of the fair market value of trust assets (discussed below), averaged over the preceding calendar years (or, if less, the period during which the trust has been in existence).

Once the trust has been converted to a unitrust, the trustee must invest and manage trust assets under the Prudent Investor Act. Both Washington and Oregon provide an ordering structure for distributions, under which they are deemed to be made first from net income, as that amount would be determined if the trust were not a unitrust, then from short-term capital gains, then from long-term capital gains and finally from trust principal. This creates a sort of “worst in, first out” distribution scheme for the unitrust beneficiary, since the assets with the worst characterization from a tax perspective are deemed to be distributed first.

Under RCW 11.104A.040(b) or ORS §129.225(2)(b), a trustee wanting to convert to a unitrust must give 60 days’ notice to enumerated beneficiaries, disclosing the intent to convert and the effect of the conversion. If a beneficiary objects within 60 days of notification, the trustee may not convert. The trustee also has the option to petition the court for an order to convert to a unitrust. Each of RCW 11.104A.040(l) and ORS §129.225(6) lists the circumstances under which a trustee may not exercise the power to convert to a unitrust.

There are important differences between the Washington and Oregon statutes. The Washington statute specifically applies to trusts initially created as unitrusts, as well as to trusts converted to unitrusts after creation. The Washington statute specifically requires that the conversion notice must be given to both a current permissible distributee of income and to one who would be a permissible distributee of principal if the current distributee’s interest terminates. In both Washington and Oregon, conversion can happen either by agreement or by petition to the court (under RCW 11.96A in Washington), Washington but not Oregon law specifically allows a trustee to release the power to convert to a unitrust.

The most important distinction between Oregon and Washington law is in the available unitrust distribution. The Oregon statute mandates a distribution of four percent of the fair market value of trust assets. Washington, on the other hand, allows the trustee to choose a unitrust distribution percentage of between three and five percent, or (if the trustee does not so choose) a default amount of four percent of trust assets.

There are drawbacks to a unitrust conversion. As at least one commentator has pointed out, [105] a unitrust amount of 4% could erode the trust principal over time. Further, using the unitrust approach may incur additional cost and delay if court filing or approval is required for opting in or opting out. Regardless of whether the adjustment power or the unitrust conversion is used, the trustee must have a well-reasoned approach in determining the reasons for the technique chosen, and in the case of the adjustment power, the amount used, to avoid any imputation of favoring one beneficiary over another. [106]

In a New York case, [107] the grantor created a trust under which the spouse received income during her lifetime and his children (two sons and two daughters) would receive the principal upon the death of the spouse. The trust provided that the spouse was entitled to receive the greater of $40,000 or the total income of the trust. As named successor trustees, the grantor’s sons became trustees in 1997. From 1997 until 2001, the spouse received an average of $190,000 in trust income per year. In 2003, the trustees elected to change the trust to a unitrust retroactively. As a result of the unitrust election, the spouse received approximately $70,000 per year. Additionally, the spouse owed money to the trust as a result of the retroactivity of the unitrust election. The spouse sought to have the unitrust election voided.

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105 Moore & DeHaan, Trustee’s Choice: The If, How and When of the UPIA, 153 Trusts & Estates 41, 47 (May 2014).
106 Id.
107 In re Heller, 849 N.E.2d 262 (N.Y. Ct. App. 2006).

In In re Heller, the court held that the trustees were not prohibited from changing the trust to a unitrust merely because the trustees are interested beneficiaries of the trust, especially considering that the trustees were only two of the four beneficiaries. [108] The court also held that the statute that granted the trustees the power to convert a trust to a unitrust included language that foresaw retroactive election of unitrusts. Therefore, the trustees' retroactive election was a valid exercise of trustee powers. [109] Note, however, that New York changed the law in 2008 to limit the retroactivity of the unitrust election.

In another New York case [110], the New York Surrogate's Court approved the trustee's unitrust election, retroactive to the beginning of the year in which the election was requested, because the unitrust would provide the sole income beneficiary with greater annual income for her current health care needs without depleting the trust principal.

J. Miscellaneous.

Washington law contains two miscellaneous provisions not included in the Uniform Act. First, RCW 11.104A.901 makes clear that the TEDRA statute (RCW 11.96A) applies to issues, questions or disputes arising under RCW 11.104A. Second, RCW 11.104A.907 clarifies that terms relating to marriage apply equally to state registered domestic partnerships.

108 Id. See also In re Heller, 23 A.D.3d 61, 800 N.Y.S.2d 207 (App. Div., 2d Dept. 2005) (trial court stated that statute granting election of unitrust status does not prohibit, per se, election by interested trustee; rather, court must consider facts and circumstances, including (i) nature, purpose and expected duration of trust, (ii) intent of grantor, (iii) identity and circumstances of beneficiaries, (iv) need for liquidity, (v) regularity of payment, and (vi) preservation and appreciation of capital).
109 In re Heller, 849 N.E.2d 262 (reversing trial court's determination that trustees could not elect unitrust status retroactively).
110 In re Moore, 41 Misc. 3d 687, 971 N.Y.S.2d 419 (Sur. Ct. 2013).

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