



Senate Fiscal Agency
P. O. Box 30036
Lansing, Michigan 48909-7536

BILL ANALYSIS



Telephone: (517) 373-5383
Fax: (517) 373-1986
TDD: (517) 373-0543

House Bill 5307 (as reported without amendment)
Sponsor: Representative William Van Regenmorter
House Committee: Judiciary
Senate Committee: Judiciary

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RATIONALE

A principal and income statute contains the primary accounting rules for trustees and personal representatives of estates. The rules apply to a trust created in a will, to an irrevocable trust created during the lifetime of the settlor (the person creating the trust), or to the estate of a decedent, when the terms of the trust or will do not provide differently. The statute provides procedures for fiduciaries to distinguish between property that is income (which is distributed to "income beneficiaries") and property that is principal (to which "remainder beneficiaries" are entitled when the income interest ends). The statute also indicates whether expenses and other disbursements are to be allocated to income or principal. In 1931, the National Conference of Commissioners on Uniform State Laws (the Uniform Law Commissioners) promulgated the original principal and income act. That act was revised in 1962 and adopted by 41 states; Michigan enacted the Revised Uniform Principal and Income Act in 1965.

In 1997, the Uniform Law Commissioners promulgated the Uniform Principal and Income Act to reflect modern investment theory, accommodate prudent investor rules, clarify the allocation of acquired assets, provide for types of investments (e.g., derivatives, options, and deferred payment obligations) that did not exist in 1962, and empower trustees to make adjustments between principal and income to correct certain inequities. The Council of the Probate and Estate Planning Section of the State Bar of Michigan has recommended that Michigan replace its 1965 law with 1997 version.

CONTENT

The bill would create the "Uniform Principal and Income Act" (UPIA) to prescribe the manner in which receipts and expenditures of trusts and estates would have to be credited and charged between income and principal; prescribe the manner in which income would have to be apportioned among beneficiaries at the beginning and upon the termination of a trust or estate; and repeal the Revised Uniform Principal and Income Act.

The bill would take effect on May 1, 2004, and would apply to each trust or estate existing on that date, except as otherwise expressly provided in the will or terms of the trust or UPIA. In the application or construction of UPIA, consideration would have to be given to the need to promote uniformity of the law with respect to the Act's subject matter among states that enacted it.

Fiduciary Duties

Administration of Trust or Estate. In allocating receipts and disbursements to or between principal and income, and with respect to any matter concerning a decedent's estate or a terminating income interest, or apportionment at the beginning and end of an income interest, a fiduciary (the personal representative of an estate or a trustee) would have to do all of the following:

- Administer a trust or estate in accordance with its terms, even if there were a different provision in UPIA.

- Administer a trust or estate in accordance with UPIA if the terms of the trust or will did not contain a different provision or did not give the fiduciary a discretionary power of administration.
- Add a receipt or charge a disbursement to principal to the extent that the terms of the trust and UPIA did not provide a rule for allocating the receipt or disbursement to or between principal and income.

("Income interest" would mean the right of an income beneficiary to receive all or part of net income, whether the terms of the trust required it to be distributed or authorized it to be distributed in the trustee's discretion.)

A fiduciary could administer a trust or estate by the exercise of a discretionary power of administration given to the fiduciary by the terms of the trust or will, even if doing so produced a result different from one required or permitted under UPIA.

In exercising the power to adjust between principal and income (described below) or a discretionary power of administration regarding a matter within the scope of UPIA, a fiduciary would have to administer a trust or estate impartially, based on what was fair and reasonable to all of the beneficiaries, except to the extent that the trust or will clearly required or permitted the fiduciary to favor one or more of the beneficiaries. ("Beneficiary" would mean, in the case of a decedent's estate, an heir, legatee, or devisee, or, in the case of a trust, an income beneficiary or remainder beneficiary.)

Power to Adjust; Prudent Investor. A fiduciary could adjust between principal and income to the extent the fiduciary considered necessary, if the fiduciary invested and managed trust or estate assets as a prudent investor, the terms of the trust or will described the amount that could or had to be distributed to a beneficiary by referring to the trust's or estate's income, and the fiduciary could not comply with the requirement described above (to administer the trust or estate impartially, except as otherwise required or permitted).

In exercising this discretion, a professional trustee could adopt a policy that applied to all trusts and estates, or a policy that

applied to individual trusts or estates or classes of trusts or estates, stating whether and under what conditions it would use the adjustment power and the method of making adjustments.

A fiduciary could not make an adjustment under certain circumstances, e.g., it would change the amount payable to a beneficiary as a fixed annuity or fixed fraction of the value of the trust or estate; the fiduciary was a beneficiary of the trust or estate; or the adjustment would benefit the fiduciary directly or indirectly.

Terms of a trust or will that limited the power of a fiduciary to make an adjustment between principal and income would not affect the application of this section of UPIA, unless it were clear from the terms that they were intended to deny the fiduciary the power of adjustment conferred by UPIA.

Judiciary Control. A court could not order a fiduciary to change a decision to exercise or not to exercise a discretionary power conferred by UPIA unless the court determined that the decision was an abuse of the fiduciary's discretion. A fiduciary's decision would not be an abuse of discretion merely because the court would have exercised the power in a different manner or would not have exercised the power.

If the court found an abuse of discretion, it could place the income and remainder beneficiaries in the positions they otherwise would have occupied, subject to rules described in the bill.

Decedent's Estate or Terminating Income Interest

The bill describes the responsibilities of a fiduciary upon the death of a settlor, in the case of an estate, or when an income interest in a trust ended. These include determining the amount of net income and net principal receipts, and distributing the income and receipts to the beneficiary entitled to the specific property; determining the remaining net income of an estate or terminating income interest; paying fees and expenses of administration from income or principal; and paying from principal all other disbursements incurred in connection with settling an estate or winding up a terminating income interest.

A fiduciary would have to distribute to a beneficiary who received a pecuniary amount outright the interest or any other amount provided by the will, the terms of the trust, or applicable law, from net income or from principal to the extent net income was insufficient. If a beneficiary were to receive a pecuniary interest outright from a trust after an income interest ended, and neither the trust terms nor applicable law provided for interest or another amount, the fiduciary would have to distribute the income or other amount to which the beneficiary would be entitled under the law that would apply if the pecuniary amount had to be paid under a will.

Net income remaining after this distribution would have to be distributed to all beneficiaries. The bill contains rules that would govern the determination of a beneficiary's share of net income.

Apportionment at Beginning & End of Income Interest

The bill provides that an income beneficiary would be entitled to net income of a trust from the date on which the income interest began. An income interest would begin on the date specified in the trust or, if no date were specified, on the date an asset became subject to a trust or successive income interest. The bill describes when an asset would become subject to a trust or a successive income interest.

An income interest would end on the day before an income beneficiary died or another terminating event occurred, or on the last day of a period during which there was no beneficiary to whom a trustee could distribute income.

A trustee would have to allocate an income receipt or disbursement to principal if its due date occurred before a settlor died or an income interest began. A trustee would have to allocate an income receipt or disbursement to income if its due date occurred on or after the date a settlor died or an income interest began.

The bill would provide for the treatment of "undistributed income", i.e., net income received before an income interest ended.

Allocation of Receipts during Trust Administration

The bill would require a trustee to allocate to income money received from an entity. ("Entity" would mean a corporation, partnership, limited liability company, regulated investment company, real estate investment trust, common trust fund, or other organization in which a trustee had an interest, subject to certain exceptions.)

A trustee would have to allocate to principal the following receipts from an entity:

- Property other than money.
- Money received in one distribution or a series of related distributions in exchange for part or all of a trust's interest in the entity.
- Money received in total liquidation of the company, or in partial liquidation as prescribed in the bill.
- Money received from a regulated investment company or a real estate investment trust if the money were a capital gain dividend for Federal income tax purposes.

A trustee could account separately for a business or other activity it conducted, if doing so were in the best interests of all of the beneficiaries. The trustee could make certain determinations regarding net cash receipts and the extent to which remaining receipts would be accounted for as principal or income in the trust's general accounting records. The bill prescribes how a trustee would have to account for the receipts from the sale of assets of the business or activity. The businesses and other activities for which a trustee could maintain separate accounting records include a retail, manufacturing, service, and other traditional business activity; farming; raising and selling livestock; rental property management; mining; timber operations; and an activity involving derivatives.

To the extent not allocated to income under UPIA, a trustee would have to allocate all of the following to principal: assets received from a transferor during his or her lifetime, a decedent's estate, a trust with a terminating income interest, or a payer under a contract naming the trust or its trustee as beneficiary. The bill also

identifies other money or amounts that would have to be allocated to principal.

In addition, the bill would provide for the allocation of the following:

- Receipts from rental property
- Amounts received as interest on an obligation to pay money to the trustee.
- Proceeds of a life insurance policy.
- Payments that a trustee could receive over a fixed number of years or during the life of one or more individuals because of services rendered (e.g., a pension) or property transferred to the payer.
- Receipts from a "liquidating asset" (an asset whose value will diminish or terminate because the asset is expected to produce receipts for a limited period, e.g., a leasehold, patent, or royalty right).
- Receipts from an interest in minerals or other natural resources.
- Receipts from the sale of timber and related products.
- Proceeds of the collateral financial assets of asset-backed securities.

The bill also would provide for the allocation of receipts from and disbursements made in connection with transactions in derivatives (contracts or financial instruments that give a trust the right or obligation to participate in some or all changes in the price of a tangible or intangible asset or groups of assets, or changes in a rate, an index of prices or rates, or other market indicator for an asset or group of assets).

If a marital deduction were allowed for all or part of a trust whose assets consisted substantially of property that did not provide the spouse with sufficient income from or use of the trust assets, and if the amounts the trustee transferred from principal to income and distributed to the spouse from principal pursuant to the trust were not enough to provide the spouse with the beneficial enjoyment required to obtain the marital deduction, the spouse could require the trustee to make property productive of income, convert property within a reasonable time, or exercise the power to make adjustments between income and principal. In cases not governed by this provision, proceeds from the sale or other disposition of an asset would be principal

without regard to the amount of income the asset produced during any accounting period.

Allocation of Disbursements during Trust Administration

A trustee would have to make the following disbursements from income (to the extent they were not disbursements after a settlor died or an income interest in a trust ended):

- Half of the regular compensation of the trustee and of any person providing investment advisory or custodial services to the trustee.
- Half of all expenses for accountings, judicial proceedings, or other matters involving both the income and remainder interests.
- All of the other ordinary expenses incurred in connection with the administration, management, or preservation of trust property and the distribution of income.
- Recurring premiums on insurance covering the loss of a principal asset or the loss of income from or use of the asset.

A trustee would have to make the following disbursements from principal:

- The remaining half of the disbursements for compensation and expenses for accountings, judicial proceedings, etc.
- All of the trustee's compensation calculated on principal as a fee for acceptance, distribution, or termination, and disbursements made to prepare property for sale.
- Payments on the principal of a trust debt.
- Expenses of a proceeding to construe the trust or to protect the trust or its property.
- Premiums paid on an insurance policy not described above, of which the trust was the owner and beneficiary.
- Estate, inheritance, and other transfer taxes apportioned to the trust.

A trustee also would have to pay from principal disbursements related to environmental matters, including reclamation, assessing environmental conditions, remedying and removing environmental contamination, monitoring remedial activities and the release of

substances, preventing future releases, collecting amounts from persons liable for the costs of these activities, penalties imposed under environmental laws or regulations and other payments made to comply with them, statutory or common law claims by third parties, and defending claims based on environmental matters.

If a trustee made or expected to make a principal disbursement described below, the trustee could transfer an appropriate amount from income to principal in one or more accounting periods to reimburse principal or to provide a reserve for future principal disbursements. This would apply to the following disbursements, but only to the extent the trustee had not been and did not expect to be reimbursed by a third party:

- An amount chargeable to income but paid from principal because it was unusually large, including extraordinary repairs.
- A capital improvement to a principal asset, including special assessments.
- Disbursements made to prepare property for rental.
- Periodic payments on an obligation secured by a principal asset to the extent the amount transferred from income for depreciation was less than the periodic payments.
- Disbursements related to environmental matters.

A tax required to be paid by a trustee based on receipts allocated to income would have to be paid from income. A tax required to be paid based on receipts allocated to principal would have to be paid from principal. A tax required to be paid on the trust's share of an entity's taxable income would have to be paid proportionately from income and principal, as described in the bill.

A fiduciary could make adjustments between principal and income to offset the shifting of economic interests or tax benefits between income beneficiaries and remainder beneficiaries that arose from any of the following:

- Elections and decisions that the fiduciary made from time to time regarding tax matters.

- An income tax or any other tax imposed upon the fiduciary or a beneficiary as a result of a transaction involving or a distribution from the estate or trust.
- The ownership by an estate or trust of an interest in an entity whose taxable income was includable in the taxable income of the estate, trust, or a beneficiary.

If the amount of an estate tax marital deduction or charitable contribution were reduced because a fiduciary deducted an amount paid from principal for income tax purposes, instead of deducting it for estate tax purposes, and as a result estate taxes paid from principal were increased and income taxes paid by an estate, trust, or beneficiary were decreased, each estate, trust, or beneficiary that benefited from the decrease would have to reimburse the principal from which the increase in estate tax was paid. An estate or trust would have to reimburse principal from income.

BACKGROUND

The Prefatory Note to the Uniform Principal and Income Act, prepared by the Uniform Law Commissioners, states that the 1997 revision of the 1931 and 1962 acts has two purposes: "Revision is needed to support the now widespread use of the revocable living trust as a will substitute, to change the rules in those Acts that experience has shown need to be changed, and to establish new rules to cover situations not provided for in the old Acts, including rules that apply to financial instruments invented since 1962. The other purpose is to provide a means for implementing the transition to an investment regime based on principles embodied in the Uniform Prudent Investor Act, especially the principle of investing for total return rather than a certain level of 'income' as traditionally perceived in terms of interest, dividends, and rents."

According to the Prefatory Note, the prior acts as well as the latest revision address the following four questions affecting the rights of beneficiaries:

1. How is income earned during the probate of an estate to be distributed to trusts and to persons who receive outright bequests of specific property, pecuniary gifts, and the residue?

2. When an income interest begins (e.g., when a person who creates the trust dies or when he or she transfers property to a trust during life), what property is principal that eventually will go to the remainder beneficiaries and what is income?
3. When an income interest ends, who gets the income that has been received but not distributed, or that is due but not yet collected, or that has accrued but is not yet due?
4. After an income interest begins and before it ends, how should its receipts and disbursements be allocated to or between principal and income?

"Changes in the traditional sections are of three types: new rules that deal with situations not covered by the prior Acts, clarification of provisions in the 1962 Act, and changes to rules in the prior Acts."

According to the Prefatory Note, "some of the more significant new rules" address the following issues:

- The application of probate administration rules to revocable living trusts after the settlor's death and to other terminating trusts.
- The payment of interest or some other amount on the delayed payment of an outright pecuniary gift that is made pursuant to a trust agreement instead of a will, when the agreement or state law does not provide for such a payment.
- The addition of an "unincorporated entity" concept to deal with businesses operated by a trustee, including farming and livestock operations, and investment activities in rental real estate, natural resources, and derivatives.
- The allocation of receipts from discount obligations such as zero-coupon bonds.
- The allocation of net income from harvesting and selling timber.
- The allocation of receipts from derivatives, options, and asset-backed securities.
- Disbursements made because of environmental laws.
- Income tax obligations resulting from the ownership of S corporation stock and interests in partnerships.
- The power to make adjustments between principal and income to correct inequities caused by tax elections or peculiarities in

the way the fiduciary income tax rules apply.

The Prefatory Note also describes several ways in which the 1997 revision changes or clarifies a matters provided for in the earlier acts, and discusses UPIA's coordination with the Uniform Prudent Investor Act.

ARGUMENTS

(Please note: The arguments contained in this analysis originate from sources outside the Senate Fiscal Agency. The Senate Fiscal Agency neither supports nor opposes legislation.)

Supporting Argument

For the reasons set forth by the Uniform Law Commissioners, Michigan should adopt the 1997 UPIA. While incorporating many provisions of the existing statute, the bill would update the law in three significant ways. It would expand the accounting rules to reflect the popular use of revocable living trusts as a vehicle to settle estates, instead of a will. While the current law applies to irrevocable living trusts (created during the lifetime of the settlor) and trusts created by will (as well as estates not involving trusts), UPIA also accommodates revocable living trusts, which are created in the settlor's lifetime but do not take effect until he or she dies. The bill also would address matters not covered by the older act, and provide rules for financial instruments that did not exist in the 1960s, such as derivatives. Further, it would establish rules necessary to enable fiduciaries to comply with the Michigan Prudent Investor Rule, which is contained in the Estates and Protected Individuals Code. Like the existing law, UPIA would serve as a set of default rules: The express language of the will or trust would govern regardless of any conflict with the statutory rule. Enacting the bill would bring Michigan in line with the three dozen other states that already have adopted the 1997 UPIA.

Supporting Argument

According to a representative of the Council of the Probate and Estate Planning Section, the Internal Revenue Service recently promulgated a final regulation, effective January 1, 2004, under which the IRS will respect the determination of income, for income tax purposes, under a state law that permits a trustee to make adjustments between principal and income. Although

Michigan is one of eight states that do not presently have such a law, the bill would supply the necessary statutory authority for a trustee to make these adjustments.

Legislative Analyst: Suzanne Lowe

FISCAL IMPACT

To the extent that it would affect the number of disputes over wills and trusts, the bill would have an indeterminate fiscal impact on the judiciary.

Fiscal Analyst: Bethany Wicksall

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This analysis was prepared by nonpartisan Senate staff for use by the Senate in its deliberations and does not constitute an official statement of legislative intent.