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UNIFORM PRINCIPAL AND INCOME ACT: NCCUSL MODEL

House Bill 5307 with committee amendments Revised First Analysis (1-22-04)

**Sponsor: Rep. William Van Regenmorter
Committee: Judiciary**

THE APPARENT PROBLEM:

The Revised Uniform Principal and Income Act took effect in January of 1966. The purpose of the act is to provide procedures for trustees administering an estate in separating principal from income, as well as to ensure that the intention of a creator of a trust is followed by the trustees of a trust. The procedures followed are important, as the beneficiaries of income generated by a trust or estate can differ from those named as the beneficiaries of the principal. However, the world of investments and tax law has changed greatly over the past 38 years, and the act is now woefully out of date.

In 1997, the Uniform Law Commissioners, National Conference of Commissioners on Uniform State Laws, proposed a new model act, the Uniform Principal and Income Act, to replace the one in current use. The new model act reflects changes in investment strategies and practices and incorporates changes in state and federal law. This model act was further amended by the commissioners in 2000. It has since been approved by the American Bar Association and adopted by 35 states and the District of Columbia, in whole or in part. It has been recommended that Michigan follow the action taken by other states and also adopt the new model act.

THE CONTENT OF THE BILL:

The bill would repeal Public Act 340 of 1965, known as the Revised Uniform Principal and Income Act, and instead enact a model act known as the Uniform Principal and Income Act. The bill would provide procedures for trustees when administering an estate in separating principal from income. Many current provisions would be incorporated into the model. According to information supplied by the Uniform Law Commissioners, several new provisions of the model act are as follows:

- The act would be a default statute; it would only operate when the governing instrument (e.g., trust or will) is silent.
- The bill would revise rules for assets that are not accounted for in the current act, such as allocating the receipts from all entities, including corporations, partnerships, a limited liability company, a regulated investment company, and a real estate investment trust in the same manner.
- The bill would simplify certain allocation questions, especially concerning money received as part of a liquidation.
- The bill would provide, in general, that an income receipt would be principal if it were due before a decedent died, in the case of an estate, or before an income interest began, in the case of a trust.
- Provisions of the bill would assure orderly distribution of net income and principal receipts to the appropriate beneficiaries of income when the decedent died or an income interest ended. For example, discretion would be given to pay certain expenses out of either principal or income unless there would be an adverse effect on the estate tax marital deductions or income tax charitable deductions.
- Trustees would be allowed to adjust principal and income in accordance with prudent investor rules when a trust provided for a fixed income for an income beneficiary. Adjustments would be forbidden in certain circumstances.
- The bill would depart from the NCCUSL model, however, in the section of the new act that addresses the factors that must be considered by a trustee when making adjustments between principal and income (Section 104). The nature of the departure from the model act is as follows.

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The NCCUSL model act lists several factors that a trustee must consider in deciding whether and to what extent to exercise the power to adjust between principal and income. The factors include: 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; certain aspects of the assets held in trust as detailed in the model act; the net amount allocated to income under the other sections of the act and the increase or decrease in the value of the principal assets, which the trustee could estimate as to assets for which market values were not readily available; whether and to what extent the terms of trust gave the trustee the power to invade principal or accumulate income or prohibited the same; the actual and anticipated effect of economic conditions on principal and income and effects of inflation and deflation; and the anticipated tax consequences of an adjustment.

The bill does not include the above list of factors to consider. Instead, the bill would specify that in exercising discretion to adjust between principal and income, a professional trustee (e.g., a bank) 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. The bill would make a corresponding change to Section 105 to protect these decisions from court interference unless there had been an abuse of the fiduciary's discretion.

- The bill would provide more flexibility for disbursements during the administration of a trust under certain situations.
- A fiduciary would be allowed to make adjustments between principal and income for tax purposes, and imbalances of interest that arose because of taxes could be remedied by the fiduciary.

BACKGROUND INFORMATION:

Background on the model Uniform Principal and Income Act and the amended version of the act can be viewed on the website of the National Conference of Commissioners on Uniform State Laws (www.nccusl.org).

FISCAL IMPLICATIONS:

According to the House Fiscal Agency, the bill would have an indeterminate fiscal impact on the Judiciary, depending on how it affected processes and disputes involving wills and trusts. (1-16-04)

ARGUMENTS:

For:

In general, according to information supplied by the National Conference of Commissioners on Uniform State Laws (NCCUSL), assets allocated to principal serve the interests of remainder beneficiaries of a trust and the interests of the final distributees of the assets in an estate, whereas the assets allocated to income serve the interest of income beneficiaries during the life of the trust and those beneficiaries who must be paid out of the income derived during the administration of an estate. The Revised Uniform Principal and Income Act has, since 1966, provided the procedures for trustees to fulfill their fiduciary duties in the administration of a trust or will. There have been many changes to tax laws and investment strategies in the last 38 years, and the existing act can no longer effectively guide trustees in their duties as fiduciaries. For example, there is now a greater use of revocable living trusts and financial instruments (such as derivatives) that did not exist in the 1960s.

The bill would repeal the current, outdated act and replace it with the newer Uniform Principal and Income Act. The model act incorporates many of the existing provisions, but includes several new provisions that reflect changes in investment practices and that resolve conflicts with the Prudent Investor Rule.

The current act does not accommodate prudent investor rules, brought about by the enactment of the federal Uniform Prudent Investor Act in 1994 (and reflected in Michigan's Prudent Investor Rule, Part 5 of the Estates and Protected Individuals Code). Under the prudent investor rule, a trustee is obligated to invest as a prudent investor would, and yet also is obligated to satisfy both the income and remainder (principal) beneficiaries of the trust or estate. During certain economic conditions, such as the recent recession, it is difficult under the current act to follow the prudent investor rule without skewing the returns of assets that are being managed (the portfolio). Not only would the model act accommodate prudent investor rules and portfolio-based investment principles, the bill would also allow a fiduciary to make certain adjustments to the allocations between

interest and principal so that the interests of the income and remainder beneficiaries could be satisfied. A recent federal regulation effective January 2, 2004 also will recognize these “adjustments” in regard to the tax laws, but only if there is an underlying state statute authorizing fiduciaries to make such adjustments in allocations. Therefore, the prompt enactment of the model act is necessary to give trustees the tools needed to fulfill their legal duties.

The bill would differ from the model act regarding the power to adjust between income and principal in that the model act lists a number of factors that a trustee must consider when making a decision to exercise the power to adjust. Reportedly, members of the banking industry, who as a profession provide oversight for a great many trusts, wanted the flexibility to devise their own uniform policy for handling trusts.

For:

The bill would be a “default” statute. A fiduciary would have to administer a trust or will in accordance with the provisions contained in that trust or will. However, if the will or trust did not otherwise address the issue of allocation between principal and income regarding a particular asset or receipt, then the applicable provision in the bill would prevail.

POSITIONS:

A representative of the Probate and Estate Planning Section of the State Bar of Michigan testified in support of the bill. (1-20-04)

A representative of the Michigan Bankers Association indicated support for the bill. (1-20-04)

Analyst: S. Stutzky

■ This analysis was prepared by nonpartisan House staff for use by House members in their deliberations, and does not constitute an official statement of legislative intent.