12-1-1962

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Recommended Citation
George G. Bogert, Revised Uniform Principal and Income Act, 38 Notre Dame L. Rev. 50 (1962).
Available at: http://scholarship.law.nd.edu/ndlr/vol38/iss1/2

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THE REVISED UNIFORM PRINCIPAL AND INCOME ACT

George G. Bogert*

History

Before 1931 the law with regard to the allocation of receipts and expenses between capital and income in the case of trusts had been almost entirely made by court decisions. These holdings were to a large extent harmonious, except that a sharp division had occurred between the courts of Massachusetts and Pennsylvania with regard to corporate distributions such as dividends. The former court and its adherents made the allocation on the basis of the form of the distribution, under the general theory that dividends payable in stock should go to capital and cash dividends to income. The latter court and its followers strove to do more exact justice between income and capital beneficiaries by making the source and effect of the distribution determinative, holding that the remainderman is entitled to so much of a distribution as is necessary to preserve the book value of the trust's stock as it was when the trust obtained the stock, with the remainder of the distribution credited to the income cestuis. The courts were fairly evenly divided between these two theories.

In the late 1920's the National Conference of Commissioners on Uniform State Laws decided to codify the rules on this subject, and under the guidance of Charles E. Clark, then Dean of the Yale Law School, and later a Judge of the United States Circuit Court of Appeals for the Second Circuit, the Uniform Principal and Income Act was prepared and was approved by the Conference and the American Bar Association in 1931. It has since been adopted in 24 states, although subject to various amendments framed to meet local views. The Act in the main restated the existing law, but there were some exceptions. It combined the law of trusts and of legal estates for years or for life (followed by legal remainders) and applied the same rules as to principal and income to both, whereas formerly the two types of interests had been treated separately and without much relation to each other. It was forced to make a choice between the Massachusetts and Pennsylvania rules as to corporate distributions, and adhered to the former rule on the grounds that it was much simpler and easier of application and did substantial justice between temporary beneficiaries and remaindermen. It relieved a trustee from the duty to amortize for premiums on bonds purchased for the trust, apparently on the ground that the benefits to the remaindermen from amortization were small and the burdens placed on the trustee were heavy.

Experience with the administration of the Act of 1931 showed that it needed supplementation in order to meet new problems. For one thing, there was an omission in the 1931 Act which was apparently the result of inadvertence,

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2 Appeal of Smith, 140 Pa. 344, 21 Atl. 438 (1891).
namely, the disposition to be made of probate income received by an executor and turned over to a testamentary trustee who was given a sum of money, specific other property, or the residue or a part thereof. The Conference took action in 1958 to remedy this mistake and approved a Uniform Amendment to the Act which covered the allocation of probate income.4

In 1959 the Conference was persuaded to appoint a committee to draft a complete revision of the Uniform Principal and Income Act, due to the feeling that changes in law and business practices which had taken place since the preparation of the Act in 1931 made it desirable to make some modifications and insertions in the Act. For example, the accounting and financing practices of corporations had become much more complex and varied under the stress of efforts to minimize taxation; the investment trust and its distributions by way of income and capital gains had become important; court orders requiring corporations to dispose of holdings in other corporations had created new problems; and it was felt that the rules of the old Act regarding distributions from natural resources such as oil and gas were unduly favorable to the remaindermen.

The Committee secured the services of Professor Allison Dunham of the University of Chicago Law School and the great bulk of the work in connection with the preparation of the Revised Act has been performed by him. He has, however, been aided by the Conference committee and committees of the American Bankers' Association and American Bar Association and other bar associations, as well as by individual lawyers and trust men. After nearly three years of consideration and many meetings and redrafts the proposed act was approved by the Conference at its annual meeting in Monterey, California, August 2, 1962. It was then submitted to the American Bar Association for its approval but action by that organization has been postponed until February, 1963.

**Important Differences Between the 1931 and 1962 Acts**

The new Act confines itself to equitable interests under trusts and takes no account of legal estates for years or for life followed by legal remainders. The intention is to draw a separate act having to do with legal estates, but drafting of such an act has not yet begun. This change seems desirable. In the case of equitable estates there is an intermediary to act for both parties and a principal in which both have interests. Every addition to the capital of a trust benefits the income beneficiary by giving him greater income from the additional principal, whereas a payment to a legal remainderman is of benefit to him alone; and every expenditure paid from trust capital results in a contribution by the temporary cestui because of loss of income on the capital paid out, while a payment by a legal remainderman affects him only. A large proportion of legal estates are concerned with land, while trusts are to a great extent based on ownership of securities.

The 1931 Act was prospective only as adopted in most states, and where an attempt was made to have it operate retroactively, the provision has been held unconstitutional, as depriving beneficiaries of vested principal or income interests. The result was that trustees had to apply the older principal and income rules to trusts created before the adoption of the Uniform Act, while applying the provisions of the Act as to subsequently created trusts. This was felt to be burdensome and confusing. Following the lead of a Wisconsin case which held that a retroactive clause was valid because it did not concern property interests but rather merely rules of administration (as in the case of rules regarding legal investments), the new Act has taken the bold step of making the 1962 Act retroactive, so that it will govern all subsequently arising principal and income questions, no matter when the trust arose. The Pennsylvania Supreme Court has recently overruled its earlier decision and accepted the validity of such a retroactive clause.

Section 4 of the new Act makes a change with regard to the apportionment of the income of trust property not due until after the trust began but which accrued in part before the commencement of the trust. It treats such income as to be credited entirely to the income account in the case of a living trust, but to be apportioned between capital and income in the case of a testamentary trust. The old Act apportioned such income in the case of both types

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6 In re Allis, 6 Wis. 2d 1, 94 N.W.2d 226 (1959).
7 Revised Uniform Principal and Income Act § 14:
   Application of Act. Except as specifically provided in the trust instrument or the will or in this Act, this Act shall apply to any receipt or expense received or incurred after the effective date of this Act by any trust or decedent's estate whether established before or after the effective date of this Act and whether the asset involved was acquired by the trustee before or after the effective date of this Act.
9 Revised Uniform Principal and Income Act § 4:
   When Right to Income Arises; Apportionment of Income.
   (a) An income beneficiary is entitled to income from the date specified in the trust instrument, or, if none is specified, from the date an asset becomes subject to the trust. In the case of an asset becoming subject to a trust by reason of a will, it becomes subject to the trust as of the date of the death of the testator even though there is an intervening period of administration of the testator’s estate.
   (b) In the administration of a decedent’s estate or an asset becoming subject to a trust by reason of a will
      (1) receipts due but not paid at the date of death of the testator are principal;
      (2) receipts in the form of periodic payments (other than corporate distributions to stockholders), including rent, interest, or annuities, not due at the date of the death of the testator shall be treated as accruing from day to day. That portion of the receipts accruing before the date of death is principal, and the balance is income.
   (c) In all other cases, any receipt from an income producing asset is income even though the receipt was earned or accrued in whole or in part before the date when the asset became subject to the trust.
   (d) On termination of an income interest, the income beneficiary whose interest is terminated, or his estate, is entitled to
      (1) income undistributed on the date of termination;
      (2) income due but not paid to the trustee on the date of termination;
      (3) income in the form of periodic payments (other than cor-
of trusts, except in the case of corporate dividends.\textsuperscript{10}

Section 5 of the 1962 Act covers the allocation of probate income received by a testamentary trustee and in the main follows the lines of the 1958 amendment to the old Act, to the effect that such net income is income of the trust to which it goes.\textsuperscript{11}

Section 6 of the Revised Act covers the allocation of corporate distributions received by a trustee and gives to trust capital distributions in the form of shares in the distributing corporation, rights to subscribe to its stock, liquidating dividends (including those made pursuant to court order) and capital gains distributions by investment trusts. The new Act gives to income beneficiaries dividends in the form of stock or rights in other than the distributing corporation, corporate distributions in settlement of claims for preferred or guaranteed dividends or in lieu of an ordinary cash dividend, cash dividends and income distributions of investment trusts.\textsuperscript{12}
An effort to persuade the Conference to treat as income small stock dividends up to a certain percentage of capital (say, six per cent) was unsuccessful. The practice of issuing such small stock dividends is now common, and it was felt that the owners of stock and trust settlers probably consider them income, but resistance to such treatment arose from a desire to avoid the research and computation which it would involve.

There was considerable argument over the treatment of investment trust capital gains distributions. Several courts have decided that these are trust income because they represent the profits of an investment business and it is believed that most purchasers of investment trust shares regard capital gains distributions as income, since these shares customarily produce less than three per cent in income distributions and something like two per cent in capital gains distributions and the latter are needed to make a normal income yield. However, after arguments and briefs from the investment trust representatives, the Conference changed its mind and voted to treat such capital gains distributions as trust capital.

Incidentally if this rule is generally adopted it would seem that no reasonably prudent trustee, desiring to perform his duty to produce a normal trust yield for the income account and to preserve but not to increase the capital account, and mindful of his duty to act impartially between income and remaindermen beneficiaries, would hold or buy investment trust shares, except perhaps in those trusts devoted to high income securities with capital appreciation only a secondary consideration. As additional reasons for this view it may be urged that the purchase of such shares amounts to a delegation of investment duties and results in the paying of excessive costs of administration in view of charges by both the trustee and the managers of the investment trust. Every corporate trustee having a common trust fund thus may under the Revised Act have

ordinary cash dividend, a corporate distribution is principal if the distribution is pursuant to

(1) a call of shares;
(2) a merger, consolidation, reorganization, or other plan by which assets of the corporation are acquired by another corporation; or
(3) a total or partial liquidation of the corporation, including any distribution which the corporation indicates is a distribution in total or partial liquidation or any distribution of assets, other than cash, pursuant to a court decree or final administrative order by a government agency ordering distribution of the particular assets.

(c) Distributions made from ordinary income by a regulated investment company or by a trust qualifying and electing to be taxed under federal law as a real estate investment trust are income. All other distributions made by the company or trust, including distributions from capital gains, depreciation, or depletion, whether in the form of cash or an option to take new stock or cash or an option to purchase additional shares, are principal.

(d) Except as provided in subsections (a), (b), and (c), all corporate distributions are income, including cash dividends, distributions of or rights to subscribe to shares or securities or obligations of corporations other than the distributing corporation, and the proceeds of the rights or property distributions. Except as provided in subsections (b) and (c), if the distributing corporation gives a stockholder an option to receive a distribution either in cash or in its own shares, the distribution chosen is income.

(e) The trustee may rely upon any statement of the distributing corporation as to any fact relevant under any provision of this Act concerning the source or character of dividends or distributions of corporate assets.

abundant reason for avoiding investments in investment trusts and getting similar results for his trusts at less cost through his common trust fund.

A major change in the 1962 Act concerns returns from natural resources. The 1931 Act gave royalties in their entirety to trust capital, since they were regarded as in substance the proceeds of the sale of trust property. Several states have in recent years amended the Uniform Act by providing that a fraction of the receipts from royalties be set aside as trust capital and the balance to be treated as trust income. Following the federal revenue act figures as to depletion allowances in such cases, some states have fixed the percentage to be allocated to capital as 27½. This plan is adopted in the 1962 revision, but only for items of depletable property acquired after the effective date of the new Act. It is believed to be a desirable recognition of the equities of the income beneficiary and the probable intent of the settlor, and to be in accord with the treatment of the proceeds of other assets which are subject to depletion, treated in section 11 of the new Act. Receipts from these other properties, up to five per cent per year of the inventory value, are income, and the balance

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14 Uniform Principal and Income Act § 9 (1931).
15 E.g., Tex. Rev. Civ. Stat. art. 7425b-33 (1960); Okla. Stat. Ann. tit. 60, § 175.33 (1949); Vt. Stat. Ann. tit. 14, § 3309 (1958). The latter two statutes do not expressly fix the percentage at 27½, but at that percentage "as is permitted to be deducted for depletion under the then existing laws of the United States for federal income tax purposes," and "if no provision for such deduction for depletion is made by the then existing federal laws, then twenty per cent."
16 Revised Uniform Principal and Income Act § 9: Disposition of Natural Resources.
(a) If any part of the principal consists of a right to receive royalties, overriding or limited royalties, working interests, production payments, net profit interests, or other interests in minerals or other natural resources in, on or under land, the receipts from taking the natural resources from the land shall be allocated as follows:

(1) If received as rent on a lease or extension payments on a lease, the receipts are income.
(2) If received from a production payment, the receipts are income to the extent of any factor for interest or its equivalent provided in the governing instrument. There shall be allocated to principal the fraction of the balance of the receipts which the unrecovered cost of the production payment bears to the balance owed on the production payment, exclusive of any factor for interest or its equivalent. The receipts not allocated to principal are income.
(3) If received as a royalty, overriding or limited royalty, or bonus, or from a working, net profit, or any other interest in minerals or other natural resources, receipts not provided for in the preceding paragraphs of this section shall be apportioned on a yearly basis in accordance with this paragraph whether or not any natural resource was being taken from the land at the time the trust was established. Twenty-seven and one-half per cent of the gross receipts (but not to exceed 50% of the net receipts remaining after payment of all expenses, direct and indirect, computed without allowance for depletion) shall be added to principal as an allowance for depletion. The balance of the gross receipts, after payment therefrom of all expenses, direct and indirect, is income.

(b) If a trustee, on the effective date of this Act, held an item of depletable property of a type specified in this section, he shall allocate receipts from the property in the manner used before the effective date of this Act, but as to all depletable property acquired after the effective date of this Act by an existing or new trust, the method of allocation provided herein shall be used.
(c) This section does not apply to timber, water, soil, sod, dirt, turf, or mosses.
is principal. Timber lands are not dealt with in detail by the Revised Act. The disposition of receipts from them is left to the reasonable and equitable practices of an ordinarily prudent man. An important change found in section 13 of the Revised Act is the requirement that a trustee set up out of income a depreciation reserve for property generally considered subject to depreciation. (But no depreciation allowance is to be made on realty occupied as a residence by a beneficiary or on any property for which the trustee was not making an allowance for depreciation on the effective date of the new Act.) Numerous cases have held, though, that there is no

17 Revised Uniform Principal and Income Act § 11: Other Property Subject to Depletion. Except as provided in sections 9 and 10, if the principal consists of property subject to depletion, including leaseholds, patents, copyrights, royalty rights, and rights to receive payments on a contract for deferred compensation, receipts from the property, not in excess of 5% per year of its inventory value, are income, and the balance is principal.

18 Revised Uniform Principal and Income Act § 10: Timber. If any part of the principal consists of land from which merchantable timber may be removed, the receipts from taking the timber from the land shall be allocated in accordance with section 2 (a)(3).

SECTION 2: Duty of Trustee as to Receipts and Expenditures.
(a) A trust shall be administered with due regard to the respective interests of income beneficiaries and remaindermen. A trust is so administered with respect to the allocation of receipts and expenditures if a receipt is credited or an expenditure is charged to income or principal or partly to each.

(b) . . . in accordance with what is reasonable and equitable in view of the interests of those entitled to income as well as of those entitled to principal, and in view of the manner in which men of ordinary prudence, discretion and judgment would act in the management of their own affairs.

19 Revised Uniform Principal and Income Act § 13: Charges Against Income and Principal.
(a) The following charges shall be made against income:
(1) ordinary expenses incurred in connection with the administration, management, or preservation of the trust property, including regularly recurring taxes assessed against any portion of the principal, water rates, premiums on insurance taken upon the interests of the income beneficiary, remainderman, or trustee, interest paid by the trustee, and ordinary repairs;
(2) a reasonable allowance for depreciation on property subject to depreciation under generally accepted accounting principles, but no allowance shall be made for depreciation of that portion of any real property used by a beneficiary as a residence or for depreciation of any property held by the trustee on the effective date of this Act for which the trustee is not then making an allowance for depreciation;
(3) one-half of court costs, attorney's fees, and other fees on periodic judicial accounting, unless the court directs otherwise;
(4) court costs, attorney's fees, and other fees on other accountings or judicial proceedings if the matter primarily concerns the income interest, unless the court directs otherwise;
(5) one-half of the trustee's regular compensation, whether based on a percentage of principal or income, and all expenses reasonably incurred for current management of principal and application of income;
(6) any tax levied upon receipts defined as income under this Act or the trust instrument and payable by the trustee.
(b) If charges against income are of unusual amount, the trustee may by means of reserves or other reasonable means charge them over a reasonable period of time and withhold from distribution sufficient sums to regularize distributions.
(c) The following charges shall be made against principal:
(1) trustee's compensation not chargeable to income under sub-
privilege or duty to set up such a reserve,\textsuperscript{20} and it is believed that, in view of the settlor’s recognized partiality toward income beneficiaries and current low yields on improved realty, a settlor who desires to require or permit such a reserve should be required to state this intent expressly. It is true that in tax work and corporate accounting practice such reserves are employed, but such cases do not involve income and capital beneficiaries, but rather the rights of a single owner in the management of his property.

Section 13 also contains a major change with regard to the source from which trust expenses are to be paid. Section 12 of the old Act charged to the income account all ordinary expenses of administration and the entire amount of the trustee’s compensation (except commissions computed on principal), whereas section 13 of the 1962 revision charges the income account with only one half of the trustee’s regular compensation and with “all expenses reasonably incurred for current management of principal and application of income.” The new section 13 charges capital with the other half of the trustee’s compensation. Corporate fiduciaries have been advocating a revision of the allocation of trust expenses in this manner for many years and they have been successful in procuring the acceptance of the idea in some statutes.\textsuperscript{21}

The text of the Revised Act and accompanying explanatory notes will soon be published by the National Conference. It will no doubt receive careful consideration from trust men, lawyers, and legislators who are interested in the development of the law regarding fair consideration of the interests of income and principal beneficiaries and the establishment of clear and practical rules of administration.

\begin{itemize}
  \item sections (a)(4) and (a)(5), special compensation of trustees, expenses reasonably incurred in connection with principal, court costs and attorney’s fees primarily concerning matters of principal, and trustee’s compensation computed on principal as an acceptance, distribution, or termination fee;
  \item charges not provided for in subsection (a), including the cost of investing and reinvesting principal, the payments on principal of an indebtedness (including a mortgage amortized by periodic payments of principal), expenses for preparation of property for rental or sale, and, unless the court directs otherwise, expenses incurred in maintaining or defending any action to construe the trust or protect it or the property or assure the title of any trust property;
  \item extraordinary repairs or expenses incurred in making a capital improvement to principal, including special assessments, but, a trustee may establish an allowance for depreciation out of income to the extent permitted by subsection (a)(2) and by section 8;
  \item any tax levied upon profit, gain, or other receipts allocated to principal notwithstanding denomination of the tax as an income tax by the taxing authority;
  \item if an estate or inheritance tax is levied in respect of a trust in which both an income beneficiary and a remainderman have an interest, any amount apportioned to the trust, including interest and penalties, even though the income beneficiary also has rights in the principal.
\end{itemize}

\textsuperscript{20} \textit{E.g.}, \textit{In re} Davies’ Estate, 197 Misc. 827, 96 N.Y.S.2d 191 (Surr. Ct. 1950), aff’d, 277 App. Div. 1021, 100 N.Y.S.2d 710 (1950) (no duty); Laflin \textit{v.} Commissioner, 69 F.2d 460 (7th Cir. 1934) (no privilege).

\textsuperscript{21} \textit{E.g.}, CONN. GEN. STAT. ANN. §45-119(3) (1958); WIS. STAT. ANN. §251.40(8)(c) (Supp. 1962) (75% of trustee’s fee charged against income, 25% against principal).