Meet the New Principal and Income Act—And Say Goodbye to RUPIA

Principal and income legislation is important to every lawyer who drafts wills and trusts. It provides a basic operating system for trusts and estates by setting out the rules that govern the allocation of receipts and disbursements to or between the principal and income. Knowing these rules and how they affect specific kinds of property is essential, not only in the administration of trusts and estates, but also in accomplishing a client's estate planning objectives because in some situations the statutory rules must be changed to achieve those objectives.

BY E. JAMES GAMBLE

Michigan adopted its first comprehensive principal and income legislation in 1965. Called the Revised Uniform Principal and Income Act, it was quickly dubbed "RUPIA." RUPIA has been repealed and replaced by a new principal and income act (Act No. 159, Public Acts of 2004*), which became effective September 1, 2004. With only a few changes, Michigan's new act is taken from the Uniform Principal and Income Act that was approved by the National Conference of Commissioners on Uniform State Laws in 1997. The 1997 Uniform Act has been adopted in 40 states.

Michigan's new act changes many of the old rules and adds a number of new ones. The most significant new rule gives a fiduciary who is operating under the Michigan prudent investor rule a discretionary power to transfer funds from principal to income, or from income to principal, if the trustee believes a transfer is necessary to meet its duty of impartiality. The new act applies to "each trust or decedent's estate existing on September 1, 2004, except as otherwise expressly provided in the will or terms of the trust or in this act." Act 159 § 605.

The new principal and income act provides rules for situations that can reasonably be anticipated, and it enables attorneys to identify issues that should be discussed with a client to see if the client wants to change one or more rules in the act. If a client wants a different rule to apply, placing the client's rule in her will or trust agreement will override the provision in the act. The new act is "default" legislation—it applies only to the extent that there is no contrary provision in the terms of the trust or the will. Act 159 § 103(1)(a).

The rules that require prompt attention are those that change the ways of allocating receipts and disbursements to or between principal and income. For example, distributions required to be made from an IRA, qualified pension or profit sharing plan, and other deferred compensation arrangements are now allocated 90% to principal and 10% to income if there is no contrary provision in the will or trust agreement. Act 159 § 409. The old rule, under RUPIA, required the trustee to allocate an amount to income each year that was not in excess of 5% of the asset's

*MCL 555.501-1005.

inventory value. That 5% rule also applied to receipts from "liquidating" assets, such as lottery payments, patents, and copyrights; they, too, are now allocated 90% to principal and 10% to income. Act 159 § 410. Distributions from partnerships will be treated in the same manner as corporate distributions (Act 159 § 401), which eliminates the uncertainties surrounding RUPIA's partnership rule; and the allocation rules that apply to receipts from oil and gas, timber, and other natural resources are also changed. Act 159 §§ 411–412.

The Michigan Prudent Investor Rule

A key objective of the new principal and income act is to facilitate the implementation of the Michigan prudent investor rule, which became effective on April 1, 2000.[1] Based on the Uniform Prudent Investor Act,[2] the Michigan prudent investor rule is a significant departure from the law that previously governed investments by fiduciaries. The Michigan prudent investor rule enables a fiduciary to invest for "total return," by selecting investments based on their potential for capital appreciation as well as for their dividend and interest income, and it applies the standard of prudence to the portfolio as a whole rather than focusing on individual investments. EPIC § 1503(1). The rule's central theme is the adoption of an overall investment strategy having risk and return objectives reasonably suited to the fiduciary estate. EPIC § 1503(1). Because there are no restrictions on specific types of assets under the prudent investor rule, a fiduciary may invest in anything consistent with the standards of the rule, which may result in a larger percentage of stocks in the portfolio than under prior law. EPIC § 1503(4).

The Michigan prudent investor rule applies to virtually all trusts governed by Michigan law. EPIC § 1511. It is possible to opt out of the rule; the governing instrument may provide that the prudent investor rule will not apply to the trust or it may modify the terms of the rule. EPIC § 1502(2). However, if the prudent investor rule does not apply to a trust or estate, the fiduciary will not have the power to adjust between principal and income under the new principal and income act. Act 159 § 104. Questions about the effect of a modification of the prudent investor rule usually arise in the context of the fiduciary's duty of diversification, which is now integrated into the concept of prudent investing; but that section does not require diversification in all cases. EPIC § 1504 states: "A fiduciary shall diversify the investments of a fiduciary estate *unless* the fiduciary reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying." (Emphasis added.) Special circumstances include retention of a family business or other special asset if retention of the asset is one of the trust's purposes.[3]

The emphasis on investing for total return, including return from capital appreciation, tends to reduce the amount of dividend and interest income available for distribution to the income beneficiary while increasing the value of principal. The question left unanswered by the prudent investor rule was, how can a fiduciary invest for total return and also comply with the duty to treat the income and remainder beneficiaries impartially?

The New Principal and Income Act's Power to Adjust

The answer in the new principal and income act is to give the fiduciary a discretionary power to adjust between principal and income (Act 159 § 104(1)), and to get rid of RUPIA's underproductive property rule except to the extent the rule is needed for a trust to qualify for the marital deduction (Act 159 § 413).

Under the new act, a fiduciary may exercise the power to adjust if three conditions are met: (1) The fiduciary must be investing and managing assets as a prudent investor; (2) the terms of the trust or will must describe the amount that may or must be distributed to a beneficiary by referring to the income of the trust or estate (such as a requirement that a beneficiary receive all of the income); and (3) the fiduciary must determine that it cannot meet the impartiality requirements of the act and any terms of the trust or will that require the fiduciary to favor one or more beneficiaries. Act 159 § 104(1). For example, if the assets selected by the fiduciary produce little or no income, the fiduciary can transfer funds from principal to income for distribution to the income beneficiary; but if, in a period of high inflation, the assets produce a very large amount of interest income and little capital appreciation, part of the income can be transferred to principal, even in a trust that qualifies for the marital deduction. Reg. §§ 1.643(b)-1 and 20.2056(b)-5(f)(1).

As one would expect, professional fiduciaries expressed concern about claims by beneficiaries that they had exercised the power to adjust improperly. Because the power to adjust is a significant discretionary power, it was important to include in the act the rules that apply to the exercise of a fiduciary's discretionary powers. Section 105 of Act 159 codifies basic rules that govern the remedies available to a beneficiary. A decision to exercise or not to exercise a discretionary power conferred by the new act may not be changed by a court, even though the court might have exercised the power in a different manner or would not have exercised it at all, unless the court finds that the fiduciary abused its discretion. Act 159 § 105(1). The power to adjust is specifically identified as one of the powers to which this rule applies. If the court finds an abuse of discretion, the remedies are described in section 105(3) of Act 159.

To provide further guidance to fiduciaries, beneficiaries, their counsel, and the courts about what may constitute an abuse of discretion, the official comments to section 105 of the 1997 Uniform Principal and Income Act describe the power to adjust in these terms:

> *The exercise of the power to adjust is governed by a trustee's duty of impartiality, which requires the trustee to strike an appropriate balance between the interests of the income and remainder beneficiaries. Section 103(b) [§ 103(2) of Act 159] expresses this duty by requiring the trustee to 'administer a trust or estate impartially, 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.' Because this involves the exercise of judgment in circumstances rarely capable of perfect resolution, trustees are not expected to achieve perfection; they are, however, required to make conscious decisions in good faith and with proper motives.*
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> *In seeking the proper balance between the interests of the beneficiaries in matters involving*

*principal and income, a trustee's traditional approach has been to determine the settlor's objectives from the terms of the trust, gather the information needed to ascertain the financial circumstances of the beneficiaries, determine the extent to which the settlor's objectives can be achieved with the resources available in the trust, and then allocate the trust's assets between stocks and fixed-income securities in a way that will produce a particular level or range of income for the income beneficiary. The key element in this process has been to determine the appropriate level or range of income for the income beneficiary, and that will continue to be the key element in deciding whether and to what extent to exercise the discretionary power conferred by Section 104(a). * * **

A fiduciary has broad latitude in choosing the methods and criteria to use in deciding whether and to what extent to exercise the power to adjust in order to achieve impartiality between income beneficiaries and remainder beneficiaries or the degree of partiality for one or the other that is provided for by the terms of the trust or the will. For example, in deciding what the appropriate level or range of income should be for the income beneficiary and whether to exercise the power, a trustee may use the methods employed prior to the adoption of the 1997 Act in deciding how to allocate trust assets between stocks and fixed-income securities; or may consider the amount that would be distributed each year based on a percentage of the portfolio's value at the beginning or end of an accounting period, or the average portfolio value for several accounting periods, in a manner similar to a unitrust, and may select a percentage that the trustee believes is appropriate for this purpose and use the same percentage or different percentages in subsequent years. The trustee may also use hypothetical portfolios of marketable securities to determine an appropriate level or range of income within which a distribution might fall.

An adjustment may be made prospectively at the beginning of an accounting period, based on a projected return or range of returns for a trust's portfolio, or retrospectively after the fiduciary knows the total realized or unrealized return for the period; and instead of an annual adjustment, the trustee may distribute a fixed dollar amount for several years, in a manner similar to an annuity, and may change the fixed dollar amount periodically. No inference of abuse is to be drawn if a fiduciary uses different methods or criteria for the same trust from time to time, or uses different methods or criteria for different trusts for the same accounting period.

While a trustee must consider the portfolio as a whole in deciding whether and to what extent to exercise the power to adjust, a trustee may apply different criteria in considering the portion of the portfolio that is composed of marketable securities and the portion whose market value cannot be determined readily, and may take into account a beneficiary's use or possession of a trust asset.

Section 104(2) of Act 159 provides that, in exercising the power to adjust, the trustee is to consider all factors relevant to the trust or estate and its beneficiaries. The 1997 Uniform Principal and Income Act has a list of nine "factors" for a fiduciary to consider to the extent they are relevant. The nine factors were derived from a list of eight "circumstances" that the Uniform Prudent Investor Act and the Michigan prudent investor rule require a fiduciary to consider in investing and managing trust assets. EPIC § 1503(2)(a)–(h). While the nine factors in the 1997 Uniform Act do not appear in Act 159, a fiduciary who is operating under the Michigan prudent investor rule will nevertheless have considered all but one of the nine factors in the process of investing and managing the assets. The remaining factor relates to powers to invade principal or to accumulate income (i.e., whether either power is permitted or prohibited by the terms of the trust or will and the extent to which either power has been exercised from time to time). Section 105(2)(b) of Act 159 provides that a decision regarding the factors that are relevant, the extent to which they are relevant, and the weight, if any, to be given to those factors, are all decisions to which the rule in section 105(1) applies.

To help achieve the objective of reasonable investment costs, as provided for in the Michigan prudent investor rule (EPIC § 1508), section 104(3) of Act 159 authorizes a professional trustee to adopt a policy that applies to all trusts and estates, or a policy that applies to individual trusts or estates or classes of trusts or estates, stating whether and under what conditions it will use the adjustment power and the method of making adjustments.

Section 104(4) provides that a trustee may not make an adjustment in a several situations, most of which involve tax issues. For example, a trustee may not make an adjustment that diminishes the income interest in a trust that is intended to qualify for an estate tax or gift tax marital deduction. Act 159 § 104(4)(a). The only prohibition not related to a tax issue applies to a trustee who is a beneficiary of the trust—he or she may not exercise the power to adjust. Act 159 § 104(3)(g). The kind of concern addressed by this provision is a situation where a surviving spouse is both the trustee and income beneficiary, and the remainder beneficiaries are children of a prior marriage. In cases where a trustee is not permitted to exercise a power, a cotrustee who is not prevented by section 104(4) from exercising the power may exercise it unless the terms of the trust do not permit the cotrustee to do so. Act 159 § 104(5).

A trustee may release the power to adjust if the trustee determines that possessing or exercising the power may deprive the trust of a tax benefit or impose a tax burden not contemplated in section 104(4). The release may be permanent or for a specified period, including a period measured by the life of an individual. Act 159 § 104(6). For example, it could be used by the trustee of a pooled income fund who wants to amend or reform the fund's governing instrument to eliminate the application of the power to adjust, as permitted by new IRS regulations § 1.642(c)-2(e). Section 104(6) provides that a trustee may release the entire power to adjust or may release only the power to adjust from income to principal or the power to adjust from principal to income if the trustee is uncertain about whether possessing or exercising the power causes a result described in section 104(4).

The provisions in section 104 may be changed by a provision in the terms of a trust or a will, just like any other provision in the new act, but a provision that seeks to limit the power of a fiduciary to exercise the power to adjust must show a clear intent to deny the fiduciary that power. Act 159 § 104(7).

Revisions to RUPIA

In addition to the rules previously described, Michigan's new principal and income

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act contains both new rules and revisions of many rules found in RUPIA. New rules that apply during the period of probate administration or winding up of a revocable living trust are:

- *REVOCABLE LIVING TRUSTS.* RUPIA failed to recognize the use of revocable living trusts as will substitutes, and it had no rules that applied to the winding up of a revocable living trust after the grantor died. This omission led to litigation on several occasions. The new act applies the same rules to both probate estates and terminating revocable living trusts. Act 159 §§ 201–202 and §§ 301–303. For example, income receipts at the beginning of a trust are now treated in the same manner as the receipts of a probate estate. Act 159 § 302.
- *OTHER TERMINATING TRUSTS.* RUPIA also had no provision dealing with an irrevocable trust that terminates and is followed by successor trusts (for example, a marital deduction trust that terminates when the surviving spouse dies, followed by outright pecuniary gifts to nieces and nephews, remainder in trust for the children). In this situation the new act applies rules similar to the probate estate rules. See Act 159 §§ 201–202 and 301–303.
- *ADMINISTRATION EXPENSES.* A fiduciary is now authorized to pay interest on death taxes and other administration expenses from principal or income in the fiduciary's discretion. In the case of a trust for which a marital or charitable deduction is claimed, the fiduciary may pay these expenses from income only to the extent that it will not cause a reduction or loss of the estate tax deduction. Act 159 § 201(b)(ii). This provision enables a fiduciary to determine what are "transmission" expenses and "management" expenses for estate tax purposes,[4] and then to allocate the transmission expenses to principal and management expenses to income. The rule in section 201(b)(ii) may also be changed by a provision in the governing instrument.
- *INTEREST ON PECUNIARY GIFTS.* If an outright pecuniary gift is made pursuant to a trust agreement instead of a will, and if the agreement or state law does not provide for the payment of interest or some other amount if the payment is delayed, the recipient is to receive the amount that would have been paid had the gift been made under a will. Act 159 § 201(c). This will cause the rule in EPIC § 3904 (which provides that a pecuniary devise under a will is to bear interest at the legal rate) to apply to pecuniary gifts from revocable living trusts.

There are also new rules that apply during the continuation of the trust:

- *BUSINESS ACTIVITIES.* If the trustee operates a business (or a collection of businesses, including several rental properties), the trustee is authorized to account for the business activities as though they were in a separate entity (such as a wholly-owned corporation or a single-member LLC), and to retain earnings in that "entity" for the reasonable needs of the business; only cash that the trustee identifies as available for distribution from the "entity" will be treated as trust income. Act 159 § 403. In addition to retail, manufacturing, service, and other traditional business activities, this provision will apply to activities in rental real estate, natural resources, timber, and derivatives as well as farming and livestock operations.
- *DISCOUNT OBLIGATIONS.* Zero-coupon bonds and other discount

obligations were not covered by RUPIA, which had a rule only for U.S. Savings Bonds (Series E). The new act calls for the discount on all obligations to be added to principal when received unless the obligation has a maturity of less than one year when the trustee acquires it. The trustee can exercise the power to adjust from principal to income, if necessary, to provide the income beneficiary with the appropriate amount of distribution. Act 159 § 406(2).

- ***DE MINIMIS ADJUSTMENTS.*** To simplify trust accounting adjustments, the trustee is authorized to ignore small adjustments that would otherwise be required by the wasting asset rule, natural resources rules, etc. This will apply if the adjustment is less than 10% of the income or if the asset for which the adjustment would be made has a value that is less than 10% of the total portfolio. Act 159 § 408.
- ***TIMBER.*** Specific rules for allocating net receipts from the harvesting and sale of timber are now provided in Act 159 § 412. RUPIA provided only that the allocation should be "fair and reasonable."
- ***DERIVATIVES.*** Derivatives are dealt with in section 414 of Act 159. The trustee may deal with the combined net income or loss from these activities as though they were conducted in a separate entity under section 403 of Act 159, or may allocate the income or loss to principal, subject to the power to adjust under section 104 of Act 159.
- ***OPTIONS.*** Put and call option transactions that are not part of any derivatives activities are also covered by section 414 of Act 159.
- ***ASSET-BACKED SECURITIES.*** Rules for asset-backed securities are in section 415 of Act 159.
- ***ENVIRONMENTAL EXPENSES.*** Disbursements made to comply with environmental requirements are to be paid from principal. Act 159 § 502(1)(g).
- ***INCOME TAXES.*** The income tax allocation provisions now cover tax obligations that arise if the trust owns an interest in a partnership or stock in an S corporation, including situations in which the cash distributed is different from the amount of taxable income that must be included on the trust's return. Act 159 § 505.
- ***EQUITABLE ADJUSTMENTS.*** The trustee may make equitable adjustments between principal and income to compensate beneficiaries for unfair results arising from tax elections or quirks in the way the distributable net income rules apply. Act 159 § 506.

A number of the rules in RUPIA have been clarified or changed:

- ***PARTIAL DISTRIBUTIONS FROM AN ESTATE.*** The rule that applies to partial distributions from and estate, and now to a terminating trust, has been clarified. Act 159 § 202.
- ***WHEN AN INCOME INTEREST ENDS,*** an income beneficiary or her estate will be entitled to receive only net income actually received by the trust before the income interest ends, and not any income that is due or accrued. Act 159 § 303(1).
- ***PARTNERSHIPS*** and limited liability companies will be subject to the same rules that apply to corporations. These rules will also apply to a partnership interest acquired by a trustee as an investment and not just those acquired from the decedent. Act 159 § 401.
- ***DISTRIBUTIONS FROM CORPORATIONS OR PARTNERSHIPS THAT EXCEED 20%*** of the entity's gross assets will be allocated to principal regardless of whether the entity intended it to be a partial liquidation. Act 159 § 401(4)(b).
- ***MUTUAL FUNDS.*** Short-term capital gains are treated as income under the new act (long-term capital gains are still principal). This change was made because of comments from accountants who said that many mutual funds did not show the amount of short-term gains as an item separate from ordinary income in their reports to shareholders.
- ***REAL ESTATE INVESTMENT TRUSTS.*** The rules are clarified by removing the reference to distributions from depreciation and depletion; distributions from mutual funds and REITs are now treated the same way. Act 159 § 401(3)(d).
- ***OIL AND GAS.*** Under RUPIA, 27-1/2% of the net receipts was allocated to principal and the balance to income. Under the new act, 90% of the net receipts are allocated to principal and 10% to income. Act 159 § 411.
- ***UNDERPRODUCTIVE PROPERTY.*** RUPIA provided a formula for calculating an amount of "delayed income" to be paid to an income beneficiary upon the sale of property that had produced less than 1% of its inventory value for more than one year. The new act eliminates this provision because it was regarded as a significant obstacle by portfolio managers to investing under the prudent investor rule. However, the new act does contain provisions required by the estate tax regulations to obtain a marital deduction if the assets of a marital deduction trust consist substantially of property that does not provide the spouse with sufficient income. Act 159 § 413.
- ***DEPRECIATION*** was mandatory under RUPIA but under the new act it may or may not be taken in the discretion of the trustee. Act 159 § 503.

Trust Accounting Income and the New IRS Regulations

The IRS issued final regulations on December 31, 2003 dealing with matters affected by the definition of trust accounting income.[5] These regulations recognize the validity of determining trust accounting income

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by using a power to adjust (under section 104 of Act 159) "to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries," and they characterize such a statutory provision as "a reasonable apportionment of the total return of the trust." Under the new regulations, a marital deduction trust whose income may be determined by exercising a power to adjust will meet the gift tax and estate tax requirement that all of the trust's income must be distributed to the spouse. The regulations do not indicate that there is any difference between an adjustment from income to principal and an adjustment from principal to income. Reg. §§ 20.2056(b)-5(f)(1) and 25.2523(e)-1(f)(1). In addition, for marital deduction purposes, the power to adjust will not be considered a power to appoint trust property to a person other than the surviving spouse. Reg. §§ 20.2056(b)(7)(d)(1) and 25.2523(f)-1(c)(1).

Trustees of pooled income funds, on the other hand, may want to release the power to adjust. If a pooled income fund is permitted to exercise a power to adjust but has not previously determined its income by exercising that power, the regulations permit the fund to amend or reform its governing instrument. The deadline for commencing a judicial proceeding or completing a valid nonjudicial reformation is June 1, 2005 (i.e., no later than nine months after the effective date of Act 159). Reg. § 1.642(c)-2(e). The trustee's release of the power to adjust under section 104(6) of Act 159 should satisfy the requirement for a nonjudicial reformation that is valid under state law.

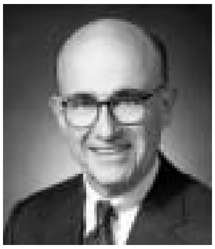
Unitrusts

The new principal and income rules do not affect unitrusts because unitrusts provide for a distribution method that is not based on principal and income concepts. A unitrust requires the trustee to distribute an annual amount that is expressed in terms of a percentage of the market value of the trust assets without regard to the amount of income the trust actually received during the year. Trust accounting income does become important, however, when the client creates a unitrust for the surviving spouse. In order to qualify for the marital deduction, the IRS requires that the payment to the spouse be the unitrust amount or the trust's accounting income, whichever is greater.

In recent years, a number of states have adopted special statutes that permit the trustee and the beneficiaries to convert an irrevocable trust, in which the settlor provided for the payment of the trust's income to the income beneficiary, to a trust providing for a unitrust amount to be paid to the income beneficiary. Such a conversion raises additional tax issues, such as whether the switch is a taxable exchange of property interests, whether a beneficiary has made a taxable gift, and whether there are adverse generation skipping transfer tax results.

In response to these issues, the new IRS regulations concerning the definition of "income" provide that a unitrust will qualify for the marital deduction and there will be no taxable exchange, taxable gift, or adverse generation skipping results if *both* the trust agreement and a state statute provide that the unitrust percentage is not less than 3% and not more than 5%. Reg. § 1.643(b)-1. Very few states have such a statute, and the IRS requirement that each state must adopt one has been criticized. The IRS has been urged to withdraw that requirement, but has not yet made a decision.

While the IRS requirement that a 3%–5% provision must be in a state statute as well as in the trust document is a problem, the conversion itself can be accomplished in Michigan without further legislation. A trustee is able to convert an income-distribution trust to a unitrust under section 105(4) of Act 159. Under that section, if a trustee believes that such a conversion will provide the income and remainder beneficiaries the degree of beneficial enjoyment contemplated by the terms of the trust, the trustee may petition the court for an order asking that a proposed exercise of the power to adjust that would convert the trust to a unitrust will not be an abuse of discretion, and the court must enter such an order unless a beneficiary who challenges the proposed exercise meets the burden of proving that the proposed exercise would be an abuse of discretion. One way of exercising the power to adjust is to emulate the unitrust distribution method, and a trustee's petition for a conversion to a unitrust would simply fix that distribution method for an indefinite period of time. However, until the issue about having a 3%–5% provision in a state statute is resolved, petitioning a court to make a switch is not recommended for trusts in which the tax issues are important. ✦



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Footnotes

[1] Estates and Protected Individuals Code (hereinafter "EPIC") §§ 1501–1512; MCL 700.1501–1512.

[2] The Uniform Prudent Investor Act and its official comments are at 7B UNIFORM LAWS ANNOTATED 280 (2000). See also RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE (1992).

[3] Reporter's comment to section 3 of the Uniform Prudent Investor Act. 7B U.L.A. 296 (2000).

[4] See Reg. §§ 20.2055-3(b) and 20.2056(b)-4(d).

[5] T.D. 9102. The regulations apply to trusts and estates for taxable years ending after January 2, 2004, except for rules that apply to pooled income funds (Reg. §§ 1.642(c)-2 and (c)-5) and charitable remainder unitrusts (Reg. § 1.664-3).