THE LEGENDARY UPIA:
WHAT YOU THOUGHT YOU KNEW AND DIDN'T

By

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I. BACKGROUND

The Uniform Principal and Income Act (UPIA) assists fiduciaries in answering the question "who gets what" in an estate or trust when the governing instrument is silent. If the will or trust answers the question, that's the end of the story. The instrument trumps the UPIA. Otherwise, the UPIA governs the determination of principal and income and the trustee must be familiar with its provisions to do his or her job properly.

The distinguishing feature of an estate or trust is that there are two classes of owners – those entitled to the income and those entitled to the remainder. This dichotomy of interests naturally creates tension between the classes. Receipts determined to be income will benefit the income beneficiary to the detriment of the principal beneficiary and vice versa. The tension worsened in the 1990s when total return investing became popular. Total return investing seeks to obtain an overall rate of return rather than a certain level of "income" as traditionally understood. Total return investing tends to skew the portfolio toward equities and away from income producing assets, to the detriment of the income beneficiary.

To relieve this tension, the Uniform Laws Commissioners drafted the Uniform Principal and Income Act (1997), and amended it in 2008.[1] Its mission was two-fold. First, it modernized the definition of income for some of the newer and riskier investment vehicles that trustees are now investing in, such as limited partnerships, annuities, IRAs, options, derivatives, mutual funds, and the like. Second, it granted trustees investing for total return under the prudent investor rule the power to adjust between principal and income. The power to adjust does not apply to estates because they are not bound by the Uniform Prudent Investor Act. The power to adjust allows the trustee to invest for total return, but adjust where necessary between principal and income to be fair and impartial to both classes of beneficiaries.[2]

Texas adopted the 1997 UPIA in 2003, and incorporated the 2008 amendments in 2009 and 2011. However, Texas substantially modified many of its provisions.[3] The Texas UPIA applies to every trust existing or created in Texas on or after January 1, 2004 and every estate of a Texas decedent who died on or after January 1, 2004, unless the instrument states otherwise. It also applies to Texas decedents who died before January 1, 2004, if the probate or estate administration was pending as of January 1, 2004.[4]

II. SCOPE

The Texas Trust Code, and thus the UPIA, applies to all express trusts. An express trust arises when a person with legal and equitable dominion over property executes an intention to create a trust and makes the property subject to it.[5] The Texas Trust Code does not cover

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[1] http://www.uniformlaws.org.; The UPIA § 409 was amended in 2008 to comply with Rev. Rul. 2006-26 regarding marital trusts that are beneficiaries of a IRA and UPIA § 505 was amended to clarify how income taxes on undistributed taxable income of a pass-through entity must be allocated between principal and income.

[2] Prefatory Notes to UNIF. PRINCIPAL AND INCOME ACT (1997), available at www.uniformlaws.org.

[3] TEX. PROP. CODE §§ 116.001-116.206.

[4] Section 5(b) of Acts 2003, 78th Leg., ch. 659.

[5] TEX. PROP. CODE § 111.004(1)(B)(4); Mills v. Gray, 210 S.W. 2d 985, 987 (Tex. 1948), quoting from Am.Jur. 22.

resulting trusts, constructive trusts, or business trusts. A resulting trust arises when an express trust fails and the property reverts back to the grantor. A constructive trust is generally created to remedy a wrong by recovering property from one who should not be allowed to keep it.[6]

A. Revocable Trusts

The UPIA applies to revocable as well as irrevocable trusts, unless otherwise provided by the trust instrument. In fact, one of its primary goals was to "support the now widespread use of the revocable living trust as a will substitute."[7] While the UPIA generally treats revocable and irrevocable trusts the same, there are a few exceptions. For example, a revocable trust may limit the trustee's duty to respond to a beneficiary's demand for an accounting or limit the trustee's common law duty to keep the beneficiary informed.[8] But practically speaking, one would not expect too many disagreements over principal and income of a revocable trust when the grantor and the beneficiary are the same. But when the grantor dies, the beneficiary may care greatly how principal and income are defined. Unless the trust instrument provides otherwise, when the grantor of a revocable trust dies, any undistributed income is added to principal.[9]

B. Discretionary Trusts

The UPIA applies to both trusts that are required to distribute income and those that grant the trustee discretion to distribute income.[10] If the trustee of a discretionary trust decides not to distribute all the trust's income, leaving a balance of income at the end of the year, it is important to know whether this balance carries forward as income to be distributed to the income beneficiary in future years, or whether it becomes principal. The UPIA does not expressly answer this question, except on termination of a revocable trust as discussed above. If an irrevocable trust instrument does not expressly provide what happens to the accumulated income, the UPIA would likely transfer it to principal under the default rule.[11]

C. Charitable Trusts

The Texas Trust Code, of which the UPIA is a part, applies broadly to all "express trusts," except resulting trusts, constructive trusts, business trusts, and security instruments (i.e. deeds of trust).[12] Thus the UPIA applies to charitable trusts, unless the governing instrument provides otherwise. Various provisions of the UPIA clarify its application to charitable trusts. For example, the UPIA provides that the trustee may not exercise a power to adjust for amounts permanently set aside for charitable purposes under a will or trust unless both the income and

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[6] Johanson's Texas Probate Code Annotated, TEX. PROP. CODE § 111.003, Commentary.

[7] Prefatory Notes to UNIF. PRINCIPAL AND INCOME ACT (1997), available at www.uniformlaws.org.

[8] TEX. PROP. CODE § 111.0035(b)(4), (c).

[9] TEX. PROP. CODE § 116.103.

[10] TEX. PROP. CODE § 116.002(6).

[11] TEX. PROP. CODE § 116.004(a)(4).

[12] TEX. PROP. CODE §§ 111.003, 111.004(4) (An express trust is a fiduciary relationship with respect to property which arises as a manifestation by the settlor of an intention to create the relationship and which subjects the person holding title to the property to equitable duties to deal with the property for the benefit of another person.)

principal are so set aside.[13]

In practice, however, most charitable trusts will have their own distribution provisions designed to qualify for the intended tax benefits. For example, a charitable remainder trust must pay either a fixed annuity or a percent of the trust's asset values each year under IRC § 664(d) in order for the donor to claim an income tax deduction for the value of property contributed to the trust. Similarly, a private foundation is required by law to make annual distributions to charities equal to 5 percent of its investment assets or pay an onerous excise tax.[14] And if the trust instrument of a private foundation does not provide for a 5 percent distribution, the Texas Trust Code considers it to contain that provision.[15]

D. Pet Trusts

And last, but not least, the UPIA even applies to Texas' new trusts for animals, otherwise known as Pet Trusts.[16] Most pet trusts have a fairly short duration because they must terminate at the latest on the death of the animal(s) the trust is created to care for. But the sums left in pet trusts can be significant. Oprah Winfrey has reportedly set aside $30 million dollars for her pets. In 2007 real estate heiress Leona Helmsley bequeathed $12 million to her Maltese dog in trust. She also ordered the dogs remains to be buried next to her in the Helmsley Mausoleum. However, when the dog died four years later, the cemetery denied her request because it did not allow pet remains. And so the pet was cremated.

Amounts left in pet trusts should be reasonable because they are not deductible for estate tax purposes, even if the remainder is left to charity. Leona Helmsley's dog was expensive to maintain, requiring about $20,000 annually for basic living expenses, $60,000 for a caretaker, and $100,000 for security to protect the animal against dog-napping and death threats. But even this did not require $12 million. So Helmsley's executors petitioned the New York Surrogate's Court for permission to reduce the amount passing to the pet trust to $2 million. The New York pet trust statute, like the Texas statute, allows the court to reduce the amount passing to a pet trust if it determines that the amount substantially exceeds the amount required for the intended use. [17] The excess passes to the remainder beneficiaries of the pet trust, or if the pet trust is silent, to the settlor's beneficiaries under the will.[18] Therefore, the trustee must consider the remainder beneficiaries in making investment decisions and allocating between principal and income.

E. Situs

In most cases, the trust's governing instrument will specify its situs. Situs refers to the state that has jurisdiction over the trust. The designation of situs in the trust instrument generally controls. If the will or trust does not designate a situs, testator or grantor's domicile at the time of

[13] TEX. PROP. CODE. § 116.005(c)(3).

[14] IRC § 4942(e)(1); § 4942(a), (b) (imposes a 30 percent excise tax on the undistributed income of a private foundation and a 100 percent additional tax if the failure is not corrected by the end of the following year.)

[15] TEX. PROP. CODE 112.055(a).

[16] TEX. PROP. CODE § 112.037 (added by H.B. 1190, 79th Leg., 1st Sess. (Tex. Leg. 2005).

[17] TEX. PROP. CODE § 112.037(d).

[18] TEX. PROP. CODE § 112.037(e).

death or creation of the trust will generally determine the situs because it reflects what state laws the settler probably had in mind when it drafted the instrument. Situs is important because it determines the trustee's powers and duties, the meaning of the trust's terms, where it may be taxed, and many other critical factors. More than one state can have jurisdiction over different aspects of the same trust. For example, one state may control its definitions, another may control matters pertaining to its administration, and a third can govern whether it is a valid trust.

What's more, the trust situs can change. This can happen either because a corporate trustee changes its principal place of administration, an individual trustee changes his or her domicile, or the trustee or beneficiaries petition the court for a change in situs. A trustee may want to change the trust situs if the beneficiaries can benefit from a state with more favorable tax laws, a more favorable definition of trust income, or a longer duration for trusts.

III. DECEDENTS' ESTATES

A. Governing Instrument Controls

When a person dies, or an income interest ends, it is important to remember that the governing instrument prevails over any contrary provision in the UPIA.[19] That means that if the decedent's will provides for the treatment of income or an asset of the estate, the UPIA does not apply. This principle was illustrated in *Bigsby v. Vogel* involving the estate of Maxine Vogel in the Oregon Court of Appeals.[20] Maxine's will created a testamentary trust to hold her real estate and pay income to her husband for life with the remainder to her children. Her will also gave "all the rest, residue, and remainder of my estate, real, personal or mixed, of which I may die seized or possessed or to which I may be entitled at the time of my death, to my husband, absolutely and without limitation." At the time of her death she owned a ranch worth about $1.5 and a receivable of $148,864 for crop share proceeds, conservation payments, and forfeited earnest money from a failed attempt to sell the ranch.

Two months after Maxine died, her husband and executor sold the ranch and deposited the proceeds in the testamentary trust. He also paid himself the $148,864 of crop share, conservation, and earnest money proceeds, considering them personal property passing under the residuary clause. However, the children argued that the $148,864 should be allocated to principal under the Oregon UPIA because the will was silent on how to allocate postmortem receipts. It is not clear which provision of the Oregon UPIA they relied on. They may have claimed that the $148,864 was proceeds from the sale of a principal asset owned at the time of death or that it was principal under the default rule, which allocates receipts to principal if neither the UPIA nor the governing instrument provide otherwise.

Nonetheless, the court held that the will *did* provide otherwise because it clearly directed that, except for the ranch, all the rest and residue of the estate goes to her husband. Thus the money belonged to the husband and the UPIA was inapplicable. This is an excellent illustration of how a will can trump the UPIA.

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[19] TEX. PROP. CODE § 116.004(a).
[20] Bigsby v. Vogel, 273 P.3d 284 (2012).

B. Specific Bequests

Net income and principal on property specifically bequeathed must be given to the beneficiary who is to receive the specific property.[21] Thus dividends on specifically bequeathed stock must be paid to the legatee. Likewise, the net rental income on rent property specifically bequeathed must be paid to the devisee. The fiduciary may not use that income to pay administrative expenses.[22] The fiduciary may, however, make a reasonable provision for amounts it may become obligated to pay after paying the specific bequest. For example, it may estimate and prorate the real estate taxes it expects to owe after distributing the real estate.

C. Estates Generally Follow UPIA

After setting aside income on specific bequests, the estate fiduciary must follow the UPIA to determine the remaining net income of the estate.[23] However, the fiduciary may use his or her discretion to pay the estate's attorneys, accountants, fiduciaries, court costs, other expenses of administration, and interest on death taxes from either income or principal. All other disbursements in connection with the settlement of an estate or a terminating income interest, including debts, funeral expenses, burial, family allowances, death taxes and penalties that are apportioned to the estate or terminating income interest by the governing instrument or local law are allocated to principal.

A recent California Court of Appeal decision illustrated that a court order can trump these UPIA provisions. In *MacNee v. MacNee*, the husband petitioned the court to pay him a family allowance during the administration of the estate. The court agreed, but ordered that it be paid from income, rather than principal as provided under the California UPIA.[24] Daniel MacNee objected to the payments coming from income because he was already entitled to all of the income from the trusts created in the estate. His step-children objected to the payments coming from principal because they would ultimately bear the cost as remainder beneficiaries of the trust, and because Daniel would get a windfall by receiving all the trust income and the family allowances. The appeal court upheld the court order to pay the family allowance from income on the basis that the UPIA only applied to family allowances provided for under the will. Because Daniel MacNee petitioned for it, the UPIA did not direct the fiduciary how to allocate it.

D. Interest on Pecuniary Bequests

A fiduciary is obligated to pay interest on a pecuniary bequest as provided for under the governing instrument. If the governing instrument is silent, interest is to be paid at 6 percent and begins one year after the decedent's death.[25] Interest on pecuniary bequests must be paid from income, or from principal if the net income is insufficient. It may not be paid from income received from property specifically bequeathed.

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[21] TEX. PROP. CODE § 116.102(a); 116.051(1).
[22] TEX. PROP. CODE § 116.051(5).
[23] TEX. PROP. CODE § 116.051(2).
[24] MacNee v. MacNee, 2012 WL 268433 (Cal. App. 4 Dist.).
[25] TEX. PROP. CODE § 116.051(3).

IV. APPORTIONING INCOME BETWEEN PERIODS

Assuming that the UPIA controls, it provides a means to apportion income received and disbursements paid by an estate or trust after a decedent dies or at the beginning of an income interest in a trust.

A. Death or Beginning of an Income Interest

Income and expenses that are due *before* death, or the beginning of a successive income interest, but paid afterward are principal.[26] The due date is the date the payor is required to make a payment. For example, dividends are due on the record date. If there is no record date, they are due on the declaration date.[27] A payment with no due date is treated as accruing daily. The portion accruing before death is principal and the balance is income.

Periodic income and expenses due after death are treated as income.[28] Periodic means paid at regular intervals under a lease or an obligation to pay interest or if an entity customarily makes distributions as regular intervals.[29] The UPIA comments provide additional examples of periodic payments such as rents, dividends, interest, annuities, and the interest portion of a mortgage payment. Allocating periodic payments due after death entirely to income was intended to assist the surviving spouse who may have become dependent on a regular flow of cash from the decedent's portfolio.

> **Example.** Sam died on June 15, 2012 owning $1,000,000 of U.S. Treasury Securities paying six percent interest, or $30,000 each January 1 and July 1. His entire estate passes into trust for his son Billy. When Sam died, his estate was owed the July 1 payment of $30,000. It should be entirely allocated to income because the payment is periodic and its due date fell after Sam's death.

These rules should not be confused with accrued interest for estate tax valuation purposes under IRC § 2031 and income in respect of a decedent (IRD) under IRC § 691, which would include $27,500 of interest income as an asset of the gross estate in the above example.[30] The income beneficiary who received the $30,000 would be entitled to deduct the estate tax attributable to the $27,500 included in the decedent's taxable estate.[31]

Although not mentioned in TEX. PROP. CODE § 116.102 or its comments, required minimum distributions from an IRA would seem to be periodic payments with a specified due date of December 31st of each year.[32] However, such payments are subject to special allocation rules under TEX. PROP. CODE § 116.172.

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[26] TEX. PROP. CODE § 116.102(a).
[27] TEX. PROP. CODE § 116.102(c).
[28] TEX. PROP. CODE § 116.102(b).
[29] TEX. PROP. CODE § 116.102(c).
[30] Reg. § 20.2031-4 (accrued interest from Jan. 1 to June 15 of $27,500 on the date of death is an asset of the gross estate and should be reflected on Form 706 [5.5/12 X 6% × $1,000,000].
[31] Reg. § 1.691(c)-1(a).
[32] Reg. § 1.401(a)(9)-5, A-1(c).

> **Example.** Sam is taking required minimum distributions from his $3 million IRA each December. He died on July 1, 2012 and named a QTIP trust as sole beneficiary of his IRA. In December 2012, the IRA custodian pays the trustee the $120,000 required minimum distribution for 2012. Because it is a periodic payment with a due date after Sam's death, the payment is income to the QTIP trust to the extent provided in the UPIA.[33] Thus, it is income to the extent of the internal income of the IRA, if the trustee can determine it. Otherwise, it is income to the extent of four percent of the IRA value on July 1, 2012, prorated for the number of days in 2012. In this case, it is income to the extent of $60,000 [6/12 X 4% X $3,000,000]

If an income receipt or disbursement is not periodic or has no due date, it must be accrued daily, with the portion accruing before death allocated to principal and balance to income.

> **Example.** Sam died on December 5, 2011 while still employed. His employer owes him $15,000 for his final paycheck due December 15, 2011. The payment has a due date, but it is not periodic under the meaning of the UPIA. Therefore, the portion accruing before death, or all $15,000, must be allocated to principal.

> **Example.** John died on June 30, 2012 leaving his entire estate to a trust for his wife Jane. The trustee is required to pay her all of the trust income for life. Before he died, John filed an amended Form 1040 for 2010. On October 1, 2012, John's executor received the income tax refund along with accrued interest from April 15, 2011 through September 30, 2012. Because the payment is not periodic and has no due date, the interest that accrued from April 15, 2011 to June 29, 2012 is allocated to principal and the balance is payable to Jane as the trust income beneficiary.

B. End of an Income Interest

When a discretionary income interest ends the UPIA does not expressly provide whether the undistributed income is principal or income, except on termination of a revocable trust as discussed below. If the trust instrument does not provide what happens to the undistributed income of an irrevocable discretionary trust, the UPIA would likely transfer it to principal under the default rule.[34] But in the case of a mandatory income distribution trust, the trustee must pay the beneficiary his share of the undistributed income up to the date the income interest ends.[35]

> **Example.** Joe Brown created an irrevocable trust that pays his son Charlie the income for life. At the time of Charlie's death, the trust had $10,000 of undistributed income. The $10,000 of undistributed income must be paid to Charlie's estate.

This principal was illustrated in the *Matter of Trusteeship of Mary Lotz*, where the trustee decided to pay the undistributed income of a mandatory income distribution trust to the remainder beneficiaries of the trust instead of to the income beneficiary's estate.[36] When the

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[33] TEX. PROP. CODE § 116.172(j).
[34] TEX. PROP. CODE § 116.004(a)(4).
[35] TEX. PROP. CODE § 116.103(b).
[36] In the Matter of Trusteeship of Mary F. Lotz, 2012 WL 1439352 (Iowa Court of Appeals denied the trustees

estate beneficiaries complained, the Iowa Court of Appeals held that the undistributed income should be paid to the decedent's estate under Iowa UPIA § 637.303(2).

On the other hand, if the trust is revocable, or the beneficiary has an unqualified power to revoke more than five percent of the trust immediately before the income interest ends, the undistributed income from the revocable portion of the trust must be added to principal.[37] This rule is designed to prevent the trustee from having to pay the grantor's estate a mandatory income payment when he clearly intended all his assets to be distributed to the trust.[38]

> **Example.** Joe Brown created a revocable trust that pays himself the income for life. At the time of Joe's death, the trust had $10,000 of undistributed income. The $10,000 of undistributed income must be added to the trust principal.

If the governing instrument provides that any undistributed income is to become a part of principal at the termination of the income interest, no undistributed income is due to the beneficiary or his estate.

V. RECEIPTS AND DISDURSEMENTS

The following summary is not meant to be all inclusive. It contains only the provisions that are the most important and of broad general interest to accountants, attorneys, trust and officers. It is important to note that these new rules are default rules only. They apply only if the governing instrument is silent. And even then, they will only answer about 70 to 80 percent of the questions. Where possible, the settlor and drafting attorney should try to anticipate the gaps and fill them in with language in the governing instrument.

A. Receipts

Most trusts and wills are drafted to default to the state law definition of income rather than provide their own definition. The most commonly encountered rules are discussed below.

1. Receipts from Entities

The Uniform Principal and Income Act treats money distributions from "entities" as income and property distributions as principal.[39] Entities include corporations, partnerships, limited liability companies, regulated investment companies, real estate investment trusts, common trust funds, and any other organization in which a trustee has an interest (except a trust, estate, a business activity, or an asset-backed security to which other sections of the Act apply.)

However, any money distributed in complete or partial liquidation of the entity is principal. A partial liquidation is one that the entity "indicates" as a partial liquidating distribution regardless of the size of the distribution.[40] A trustee may rely on a statement made

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request to pay undistributed income to the remainder beneficiary, holding that it belonged instead to the estate of the deceased income beneficiary under the Iowa UPIA § 637.303(2).)

[37] *Id.*

[38] *Id.*, comments.

[39] TEX. PROP. CODE §§ 116.151.

[40] *Id.* at § 116.151(d)(1).

by an entity about the source or character of a distribution if the statement is made at or near the time of distribution by the entity's board of directors or other person or group authorized to exercise powers similar to a board of directors.[41]

In *Manson v. Shepherd* a California Appeal Court determined that a corporation's board had sufficiently "indicated" that a $3 million distribution to its shareholders was principal by stating in its minutes that the cash arose from selling its High Street property, which was apparently a significant asset.[42] From those minutes, the court inferred that the corporation had made it known, or "indicated," at the time of the board meeting that the distribution was a liquidating distribution under § 16350(d)(1)(A) of the Cal. Uniform Principal and Income Act and was properly allocated to principal.

If the entity is silent about whether the distribution is a partial liquidating distribution, the trustee can rely on the 20-percent rule. A distribution or a series of related distributions that exceeds 20 percent of the entity's gross assets is considered a partial liquidation.[43] However, the portion of the distribution that equals the income tax due on the entity's taxable income is ignored in calculating the 20 percent.[44] Although the Act resolved some of the issues regarding income from entities, it leaves several more unanswered questions.

In determining whether a distribution, or series of distributions, is in partial liquidation because it exceeds 20 percent of the entity's gross assets, the trustee needs the entity's financial statements for the year ended immediately before the distribution (or first distribution of a series). The entity may prepare its financial statements on GAAP, fair market value, or any other method it deems appropriate. For example, in 2004 when Microsoft declared a dividend that exceeded 30 percent of its book value, trustees could use Microsoft's December 31, 2003 audited financial statements included in its Form 10-K filing with the SEC.

If the entity prepares its financial statements using historical cost and its assets have appreciated substantially, the 20-percent rule favors the principal beneficiary because distributions are more likely to exceed 20 percent of gross assets and be treated as principal. Note also the control that the entity has over the trust's income or principal. The entity can specify that a distribution is either a partial liquidating distribution or not by merely stating so. In addition, the entity can simply pay more than 20 percent of its gross assets if it wants to create a principal distribution for the trust beneficiaries.

The trustee can also manipulate income and principal under the 20-percent rule. For example, if the trustee transfers trust assets to an entity that makes no distributions or that distributes more than 20 percent of its gross assets, the trust has no income from that entity. Alternatively, if the entity distributes less than 20 percent of its gross assets, the trust can have a steady stream of income even if the entity is selling off corpus to support the distributions. Of

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[41] *Id.* at § 401(f).
[42] Manson v. Shepherd, 188 Cal. App. 4th 1244 (Cal. App. 6th Dist. 2010).
[43] *Id.* at § (d)(2).
[44] *Id.* at § (e).

course these maneuvers are tempered by the fiduciary's duty of loyalty to all the beneficiaries under the Uniform Prudent Investor Act.

Another criticism of the 20-percent rule is its rigidity. If a distribution exceeds 20 percent of the entity's gross assets, it is per se principal. Although TEX. PROP. CODE § 116.151(d)(1) allows a payment of less that 20 percent of an entity's gross assets to be classified as principal if the entity indicates it is principal at or near the time of a distribution, there is no corresponding rule that allows payments in excess of 20 percent to be classified as income. This is so despite that the distribution may actually represent many years of accumulated income that is no longer needed by the entity in its operations. This was probably the case with Microsoft. Some trustees treated the 2004 extraordinary distribution as income and some treated it as principal.

In addition a California Court of Appeal found the 20 percent rule susceptible of two different interpretations. In *Thomas v. Elder*, John Thomas the sole income beneficiary of a QTIP trust that owned a Subchapter S corporation. In 2001, the S corporation distributed $7.5 million of its $14.5 total assets, which was clearly a partially liquidating distribution because it was more than 20 percent of the entity's assets. Since the QTIP trust owned 16 percent of the S corporation, its share of the distribution was $1.2 million. John Thomas claimed that the $1.2 million received by the trust was income and not principal because it was less than 20 percent of the S corporation's $14.5 million of assets.[45] The Court of Appeal agreed that the statute was capable of being interpreted that way and held that the distribution was income in favor of John Thomas. In reaction, the California legislature enacted an emergency measure to clarify that distributions from an entity are principal when the total distributions to all shareholders collectively exceeds 20 percent of the entity's gross assets. However, many states still have the original language that the California court interpreted in that bizarre way. Therefore, this argument could successfully arise again in another forum.

But the problems didn't stop there. In a California Court of Appeal, *Hasso v. Hasso*, the trustee claimed that distributions from an S corporation to a trust were principal because they exceeded 20 percent of the S corporation's $133 million of "special purpose" assets. The company had prepared its financial statements on the "equity" method of accounting at the special request of a lender rather than on a GAAP consolidated basis. But a footnote to the financial statements disclosed that the company actually had $630 million of assets under a GAAP basis consolidated method of reporting.[46] This was confirmed by the company's chief financial officer in deposition testimony. Both the court and the parties struggled to interpret the company's complex financial statements. But in the end the court found that the company's true assets were $630 million rather than $133 million and classified the distributions as income.

2. Business and Other Activities Conducted By the Trustee

Operating a business may necessitate the use of funds in a manner different from how they would be allocated under the UPIA. For example, the business may need to retain the income generated by the business for working capital rather than distributing it to the income

[45] Thomas v. Elder, 21 Cal. Rptr. 3d 741 (Dec. 2, 2004).

[46] Hasso v. Hasso, 55 Cal. Rptr. 3d 667 (Mar. 6, 2007), *pet. for review denied*, No. S1511873 (May 16, 2007).

beneficiaries. For this reason, TEX. PROP. CODE § 116.153 allows, but does not require, a trustee that owns a sole proprietorship to account separately for that business activity, much like a board of directors would operate a corporation and decide the amount of a dividend to pay. As such, the trustee can set aside all or a portion of the net cash receipts for working capital, replacement of fixed assets, and other foreseeable needs. However, like a corporation, on liquidation, all such accumulated income would be treated as principal. Therefore, the trustee should take the decision to account separately for the business seriously as a permanent decision and not a quick fix to justify the lack of a distribution.

A trustee has broad authority to choose whatever accounting method is best suited to the activity regardless of whether that method differs from the method used by the decedent or other transferor.[47] Activities for which a trustee may maintain separate accounting records include:

- Retail, manufacturing, service, and other traditional business activities;
- Farming;
- Raising and selling livestock and other animals;
- Managing rental properties;
- Extracting mineral and other natural resources;
- Timber operations
- Activities to involving derivatives and options.

One opportunity that comes to mind involves oil and gas interests. Absent a separate accounting, the TEX. PROP. CODE § 116.201 requires a trustee to allocate one-half of fiduciary fees, investment advisory fees, accounting and legal fees to income and one hundred percent of all other ordinary expenses of administration, management, or preservation of trust property to income. A trustee may, however, wish to allocate some of these expenses differently for its oil and gas properties. For example, it may wish to allocate 85 percent to income and 15 percent to principal, which is how it allocates mineral receipts. Accounting for the mineral activities as a separate business allows the trustee to avoid the rigid rules of TEX. PROP. CODE § 116.201. A trustee may not, however, account separately for a traditional securities portfolio as a business in order to avoid the provisions of the Act that otherwise apply.[48]

3. Principal Receipts

The UPIA designates certain receipts as principal unless the governing instrument provides otherwise. These include assets received from a transferor during his lifetime, assets from a decedent's estate, assets from a trust with a terminating income interest, and assets from a payer under a contract naming the trust or trustee as beneficiary. In addition, the following are principal:

- money or other property received from the sale, exchange, liquidation, or change in

[47] TEX. PROP. CODE § 116.153, cmt.
[48] *Id.*

form of a principal asset, including realized profit;

● reimbursements for amounts spent on environmental matters to comply with laws, regulations, claims, and defending claims related to environmental matters;

● proceeds from property taken by eminent domain, except for separate awards for loss of income by a mandatory income beneficiary; and

● net income received during an accounting period during which there was no beneficiary to whom the trustee may or must distribute income.

While these categories of principal seem relatively straightforward, they can be overridden by the governing instrument, as illustrated in *Riverside Healthcare Association, Inc. v. Forbes*.[49] In that case, Sarah Forbes conveyed a parcel of real estate in Newport News, Virginia to the Sarah E. Forbes Riverside Trust. The trust instrument provided that it would pay her income for life and at her death would pay the remainder to Riverside Healthcare Association, Inc. (Riverside). The trust defined net income as:

> all funds received from the rental of the trust property and/or generated from or by the property and/or any proceeds from the trust property… less all funds paid by the trustee" for certain enumerated expenses such as real estate taxes, insurance premiums, and repairs to the trust property.

In 2008 the Commonwealth of Virginia took part of the property by eminent domain. Riverside asserted that the proceeds were principal under the Virginia UPIA because the trust instrument did not expressly state how eminent domain proceeds should be characterized. Nor did it expressly reject the UPIA provision allocating eminent domain proceeds to principal. However, the Supreme Court of Virginia held that the eminent domain proceeds were income according to the trust's definition of income. Further, while a trust instrument may expressly reject UPIA as a whole, it is not required to expressly reject the UPIA provisions individually. The trust may do so simply by providing a contrary treatment.

4. Rental Property and Depreciation

Unless the trustee elects to account for rental property as a business activity, the fiduciary must allocate rents from real or personal property and receipts from cancellation or renewal of a lease to income.[50] Refundable deposits, such as security deposits or advance rents, must be added to principal until the contractual obligations of the fiduciary are fulfilled. When the deposits are forfeited or the advance rents earned, the amounts will be transferred from principal to income.

If a portion of rental payments represents reimbursement to the fiduciary for capital improvements made to the leased property, the trustee may transfer an amount from income to principal under TEX. PROP. CODE § 116.204 to the extent that some of the rent is deemed to be

[49] Riverside Healthcare Assoc., Inc. v. Forbes, 709 S.E.2d 156 (2011).
[50] TEX. PROP. CODE § 116.162.

such a reimbursement. The fiduciary can also exercise the power to adjust if permitted under the UPIA.

> **Example.** The trust owns a rental office building. Office space typically leases for $20 per square foot annually. The fiduciary leases space to a tenant for $25 per square foot, but agrees to make certain improvements in exchange. The fiduciary may transfer $5 per square foot annually from income to principal as the payments are received.

The UPIA does not directly address whether a deficit in rental income is charged to income or principal. Therefore, unless the governing instrument provides otherwise, an overall deficit in income would reduce principal under the default rule of TEX. PROP. CODE § 116.004(a)(4).

The trustee may, but is not required to, transfer a reasonable portion of rental income to principal for depreciation.[51] There are several limitations on this power, however. The amount charged to depreciation may not exceed the net cash receipts from the property for the year. Thus, it appears that the trustee may not depreciate a non-income producing asset. There is no restriction on the depreciation *method* that may be used. Nor is there a requirement to provide for depreciation annually. Thus, the trustee may do it one year and not the next. However, the trustee may not depreciate real or personal property used by the beneficiary.[52] Nor may depreciation be charged during an estate administration.[53]

Trustees may not wish to provide for depreciation if they believe it is not necessary to protect the remainder beneficiaries where the value of the land is increasing. In addition, tax and accounting principles do not allow depreciation if the property is not used in a trade or business. Therefore, the drafters of the UPIA concluded that the decision to provide for depreciation should be left to the discretion of the trustee. However, the UPIA comments warn that in exercising the discretionary power to depreciate an asset, the trustee must comply with TEX. PROP. CODE § 116.004(b), which requires the trustee to be impartial, fair, and reasonable to all beneficiaries, unless the governing instrument manifests an intention to favor one over another.

5. Insurance Proceeds

Proceeds from life insurance policies and dividends on those policies are allocated to principal.[54] This allocation is consistent with the treatment of premiums on those policies, which are allocated to principal under TEX. PROP. CODE § 116.202(a)(5). However, interest accrued and paid after the proceeds are received is income. Proceeds from property insurance for the loss, damage, destruction or loss of title to a trust asset are also allocated to principal.[55] However, to the extent some of the proceeds are for the loss of occupancy or other use by an income beneficiary, loss of income, or lost profits from a business (unless the trustee accounts separately for the business under § 116.153), they are allocated to income.

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[51] TEX. PROP. CODE § 116.203.

[52] TEX. PROP. CODE § 116.203(b)(1).

[53] TEX. PROP. CODE § 116.203(b)(2).

[54] TEX. PROP. CODE § 116.164(a).

[55] *Id.*

These rules can produce some odd results. For example, premiums paid on property and casualty insurance are generally charged to income as an operating expense. Yet the *proceeds* are allocated to principal.

> **Example.** The trust pays a $5,000 premium for property and casualty insurance on its rental property, which is charged entirely to income under § 116.201(4). During the year, the property is damaged by fire. The insurance proceeds are allocated entirely to principal under § 116.164(a). However, to the extent that some of the proceeds are for the loss of income, that portion of the proceeds will be allocated to income under § 116.164(b).

In the above example, if the trustee accounted for the rent property as a separate business activity under TEX. PROP. CODE § 116.153, the trustee can allocate the proceeds differently. But if he terminates the rental business after receiving the proceeds, he must allocate the proceeds to principal because they are no longer needed in the business.[56]

Proceeds from fiduciary liability insurance policies will generally be allocated to principal to the extent they reimburse the trust for the loss of trust assets.[57] To the extent that some of the proceeds are for lost income, that portion should be allocated to income.[58] If the policy reimburses rather than pays for the trust's litigation costs, that portion of the proceeds should be allocated to income and principal in the same manner as the legal fees were allocated when they were incurred. Alternatively, the reimbursed litigation costs could be allocated entirely to principal under § 116.161(3), which allocates reimbursements not based on the loss of income to principal.

> **Example.** Trust A owns a fiduciary liability policy that reimburses the trust for lost principal and income, and pays its litigation costs in the event of a suit for breach of fiduciary duty. After extended litigation, the court found that the trustee breached his fiduciary duty by investing the trust assets in a Ponzi scheme and charged him $1 million for lost principal and $500,000 for lost income. The insurance company paid the claim in full. The trustee must allocate $1 million to principal and $500,000 to income.

Dividends on insurance policies are allocated the same way as the premiums.[59] Therefore, dividends on life and title insurance policies are allocated to principal because the premiums on those policies are charged to principal. Dividends on property and casualty insurance premiums are allocated to income because premiums on those policies are charged to income.

6. Deferred Compensation, IRAs, and Annuities

Special rules apply to receipts from IRAs, qualified plans, non-qualified plans, bonuses, annuities, insurance renewal commissions, and other types of contractual payments for services rendered or property transferred to the payor. They apply regardless of when the payments begin,

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[56] TEX. PROP. CODE § 116.153(b) and comments.
[57] TEX. PROP. CODE § 116.164(a).
[58] TEX. PROP. CODE § 116.164(b).
[59] TEX. PROP. CODE § 116.164(a).

when the right becomes subject to the trust, or whether the payment is received in a lump sum or installments. It applies to retirement plans as well as commercial or private annuities arising from the sale of property to another individual or entity.

If any part of a payment is characterized as interest or dividends, or a payment in lieu of interest or dividends, a trustee must allocate that portion to income and the balance to principal.[60] This provision only applies to certain types of deferred compensation, phantom stock plans, and similar plans whose terms characterize a payment as dividends or interest. It does not apply to IRAs and similar arrangements. For required payments from an IRA or similar arrangement the Uniform Laws Commissioners UPIA § 409(c) applies 10 percent of the payment to income and the rest to principal. If the payment is not required to be made (*i.e.*, it is a complete distribution of a retirement plan account balance to the trust) then the entire payment is allocated to principal.

Texas did not adopt the 10 percent rule in UPIA § 409. Instead, it provides that if the payment is required to be made, the trustee must allocate to income an amount equal to four percent of the fair market value of the future payment asset (i.e. IRA) on the later of when the asset first became subject to the trust or the last day of the prior accounting period.[61] Payments received in a short year must be prorated on a daily basis.

In 2006, the IRS rejected the UPIA 10-percent rule as insufficient to qualify trusts for the marital deduction when the trust is a beneficiary of an IRA or a defined contribution plan. Revenue Ruling 2006-26 explains that 10 percent of a required minimum distribution (MRD) does not represent a reasonable apportionment of the total return of the trust between income and principal because it is not based on the total return of the IRA.[62] Instead, the ruling requires that the trustee make available to the beneficiary the internal income of the IRA as if it were a separate trust governed by the UPIA. The ruling allows internal income to be determined as traditional income (i.e. dividends, interest, etc.), a 3-5 percent unitrust, or using a power to adjust.

To comply with Revenue Ruling 2006-26, the Uniform Laws Committee amended § 409 in October 2008 and provided separate rules for determining the income of a marital trust that is the beneficiary of an IRA or similar arrangement. These are discussed below. Although Texas did not adopt UPIA's 10 percent rule, it adopted the 2008 amendments for marital trusts because it was still possible, even under the four percent rule, that MRDs from an IRA would not be sufficient to distribute the entire internal income of the IRA. This could happen for example, if the surviving spouse was very young and had a life expectancy greater than 25 years. In that case, the MRD would be less than four percent of the IRA and violate the requirement in Rev. Rul. 2006-26 to make the four percent available to the surviving spouse.

The 2008 amendments to UPIA § 409 provide that trusts intended to qualify for the marital deduction under IRC § 2056(b)(5) (life estate with a power of appointment retained by the surviving spouse) or IRC § 2056(b)(7) (QTIP trusts), must follow one of the following two rules.

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[60] TEX. PROP. CODE ANN. § 116.172(b).

[61] TEX. PROP. CODE ANN. § 116.172(c).

[62] Rev. Rul. 2006-26, 2006-22 I.R.B. 939 (May 30, 2006).

(1) A trustee must determine the "internal income" of each separate fund for the accounting period as if it were a trust subject to the UPIA. Upon request of the surviving spouse, the trustee must demand that the person administering the separate fund distribute the internal income to the trust. The trustee must allocate the payment to income to the extent of the internal income of the separate fund and distribute that amount to the surviving spouse. The trustee must allocate the balance of the payment to principal. Upon request of the surviving spouse, the trustee must allocate principal to income to the extent the internal income of the separate fund exceeds payments made from the separate fund to the trust during the accounting period.

(2) If a trustee cannot determine the internal income of a separate fund but can determine the value of the separate fund, the internal income of the separate fund shall be four percent of the fund's value, according to the most recent statement of value preceding the beginning of the accounting period.[63]

(3) If the trustee cannot determine either the internal income of the separate fund or the fund's value, the internal income of the fund is deemed to equal the product of the interest rate and the present value of the expected future payments, as determined under IRC § 7520 for the month preceding the accounting period for which the computation is made.

Example. Mary Smith designated a QTIP trust as the sole beneficiary of her IRA when she died at age 75. The trust is a "qualified beneficiary" under the minimum distribution rules.[64] The trust does not separately define the "income" from the IRA. The required minimum distributions (RMD) will be computed over her husband John's 15.5 year life expectancy.[65] Assuming the IRA has a value of $1,000,000 on December 31 of the year Mary died, the RMD for the next year will be $64,516. The trustee can determine from the IRA statements that its internal income was $32,000 from interest and dividends. Therefore, John is entitled to $32,000. But if the trustee cannot determine the IRA's internal income, he must distribute four percent of $1 million, or $40,000 to John. If the trustee cannot determine either the income or the value of the IRA, he must pay John the IRC § 7520 interest rate multiplied by the present value of the expected future payments.

It is uncertain what the consequences would be if a QTIP trust fails to meet requirements of Revenue Ruling 2006-26, but has already claimed an estate tax marital deduction and the estate tax statute of limitations is now closed. One of the authors of Revenue Ruling 2006-26 informally suggested that the IRS may treat the spouse as having transferred her entire interest in the QTIP trust to the remainder beneficiaries under IRC § 2519. This would have dire consequences because the QTIP beneficiary would be deemed to have made a gift to the remainder beneficiaries. Moreover, because she retained a life estate in the QTIP, it would be included in her taxable estate under IRC § 2036. It is not certain that this position would be

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[63] TEX. PROP. CODE § 116.172(k) (Note that the UPIA § 409 provides that income may be the fund's value multiplied by a range of at least three and not more than five percent. Texas uses a four percent rate.)

[64] Reg. § 1.401(a)(9)-4, A-5(a).

[65] Reg. § 1.401(a)(9)-4, A-5(a)-1, A-7(a)(1).

upheld in court. However, it would be extremely expensive to find out.

7. Minerals, Water, and Other Natural Resources

Section 116.174 of the Texas UPIA covers the allocation of receipts from minerals, water, and other natural resources. The term "minerals" covers a lot of territory, considering that there are over 4,000 known minerals worldwide. Minerals are imprecisely defined as inorganic substances formed through geological processes that have a characteristic chemical composition, highly ordered atomic structure, and specific physical properties. Even though petroleum and natural gas can be traced back to organic sources such as dead plankton on the ocean floor in geologically ancient times, they are classified as inorganic minerals because they do not have an organic origin on human timescales.

Interestingly, it is not clear whether sand and gravel are minerals. They are clearly inorganic substances, but they lack a characteristic chemical composition and specific physical properties. The Supreme Court has considered this issue twice and reached opposite conclusions in cases involving a transfer of property with a reservation of minerals.[66] Ordinary sand and gravel are generally *not* considered minerals in private party transactions where minerals are conveyed, unless the transfer documents clearly provide otherwise. However, the Internal Revenue Code allows a 5 percent depletion deduction for sand and gravel.[67]

The UPIA refers to "receipts," but the comments refer to *net* receipts. Neither the Act nor the comments define net receipts. Presumably it means receipts after deducting expenses and production taxes. In any event, delay rentals[68] and annual rents on a lease are allocated entirely to income.[69] In addition, production payments must be allocated to income if and to the extent the agreement creating the production payment provides a factor for interest or its equivalent. The balance must be allocated to principal.

Royalties, shut-in-well payments, take-or-pay payments, and bonuses must be allocated between principal and income "equitably." The statute provides that an allocation of a receipt to principal is presumed equitable if it is equal to the amount of depletion "allowed by the Internal Revenue Code of 1986." This allocation to principal is different from every other state. Kansas, Montana, Oklahoma, and New Mexico provide that 15 percent of receipts from minerals, water, and other natural resources are allocated to principal and the balance to income. All the other states that have adopted the UPIA follow the uniform rule that 90 percent of mineral receipts are principal and 10 percent are income.

Before January 1, 2004, TEX. PROP. CODE § 113.107 allocated 27 ½ percent of gross receipts from oil and gas to principal, limited to 50 percent of the net receipts after paying expenses.[70] This 27 ½ percent dated back to the Internal Revenue Code depletion rate in effect

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[66] BedRock, Ltd., LLC v. United States, 541 U.S. 176 (2004); Watt v. Western Nuclear, 462 U.S. 36 (1983).
[67] IRC § 611(b)(6).
[68] Delay rentals are payments from the lessee to the lessor to maintain the lease during the primary term of the lease without drilling.
[69] TEX. PROP. CODE § 116.174.
[70] TEX PROP. CODE § 113.107 (repealed effective 1-1-04).

prior to October 9, 1969. Most of the oil producing states, including Texas, retained this 27 ½ percent rate in their principal and income acts. The UPIA changed the 27 ½ percent principal allocation to 90 percent in 1997. The drafters viewed the 27 ½ percent rate as undesirable because it allowed too much to be paid out as income.[71] The 90 percent allocation to principal reflected the drafters' intent to favor the principal beneficiary. It also reflected the notion that as wells are depleted, the amount received by the income beneficiary falls drastically. Allocating a larger portion of these receipts to principal allows the trustee to acquire other income-producing assets that will continue to produce income when the mineral reserves are exhausted.

The Texas State Bar Committee, however, was concerned that the UPIA 90/10 rule could produce unfairness. For example, income beneficiaries who were receiving 72 ½ percent of royalty payments could have their allocation reduced to 10 percent of the royalty payments. So the Committee departed from the UPIA and instead required that receipts be allocated "equitably." An allocation is presumed to be equitable if it is equal to the amount of depletion allowed by the Internal Revenue Code of 1986 as a deduction for depletion. This presumption is offered as a safe harbor only. It does not preclude other equitable allocations.

a. Problems With the Safe Harbor Tax Depletion

The CPAs on the TSCPA Legislative Advisory Committee expressed several concerns to the State Bar UPIA Subcommittee about using tax depletion. First, it varies greatly from year to year and from taxpayer to taxpayer. Second, the tax depletion is usually not determined until several months after the trust's year end. This delay makes it difficult for the trustee to make a timely allocation of income. Third, it is not clear whether the trustee must use the same depletion method as used on the trust's tax return. And finally, tax code depletion is complicated and may limit the otherwise "allowable" tax depletion deduction for reasons that should not bear on how oil and gas receipts are allocated among beneficiaries under state law. However, these points did not change the State Bar's opinion that allowable tax depletion is a reasonable safe harbor. Moreover, the TSCPA members could not offer a better solution.

The depletion rules for lease bonuses are a good example of the complexity of using tax depletion to determine a principal beneficiary's share of the mineral income. Lease bonuses and advance royalties are eligible for depletion only if there is production on the property.[72] But any depletion claimed on these receipts must be recaptured if there is no production before the lease expires.[73] And even if there is production, cost depletion is allowed, but no percentage depletion is allowed if the receipts are "payable without regard to production.[74] In other words, if the payments are not dependent on future production, no percentage depletion may be claimed. Therefore, because most lease bonuses are not contingent on future production, only cost depletion may be allocated to principal under TEX. PROP. CODE § 116.174.[75]

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[71] Comments to Uniform Principal and Income Act (1997) § 411, *available at* www.uniformlaws.org.
[72] Reg. § 1.612-3.
[73] Reg. 1.612-3(a)(2); Reg. § 1.612-3(b)(2).
[74] IRC § 613A(d)(5); Reg. § 1.613A-3(j)(1); Reg. § 1.612-3(a)(1).
[75] Cantrell & Spoor, FIDUCIARY ACCOUNTING ANSWER BOOK (CCH 2013 ed.), Q 13:4.

b. Trusts With Interests Acquired Before and After January 1, 2004

Notice that the statute allows the trustee to allocate receipts from minerals, water or other natural resources in the manner used by the trustee before the effective date of the new Act for oil and gas interests owned on the effective date of the Act.[76] However, the trustee must use the new method for mineral interests acquired after January 1, 2004. Thus, a trust may have mineral receipts being allocated under both the old and the new statutes. CPAs should watch for this in preparing tax returns and accountings for trusts that were in existence before January 1, 2004.

c. When Does a Trust "Acquire" an Interest?

Another question frequently raised by practitioners pertains to oil and gas interests owned by a revocable living trust that operates as a will substitute on the settlor's death. Assume a revocable living trust owns oil and gas interests on January 1, 2004. Upon the settlor's death in 2012, the trustee of the living trust transfers its oil and gas properties to the bypass and marital trusts created in the living trust document and each trust obtains a new federal ID number. Do the bypass and marital trusts "acquire" the oil and gas interests after January 1, 2004, thus requiring them to use the statute's new equitable allocation? Or are they a continuation of the old trust?

The same question arises if a trust with mineral properties decants. "Decanting" refers to the trustee's exercise of discretion, granted by the governing instrument or state statute, to transfer some or all of the trust property from the distributing trust to a receiving trust whose provisions in some way differ from the original distributing trust. The underlying rationale of decanting is that if a trustee has the discretionary power to transfer property to or for the benefit of one or more trust beneficiaries, then the trustee, in effect, has a power similar to a limited power of appointment, although exercisable in fiduciary capacity. Is the receiving trust a new trust or continuation of the old trust? Besides affecting the depletion rate, this question may affect the income, GST, and transfer tax consequences.

Keep in mind that a trust is defined as a fiduciary relationship with respect to property which arises as a manifestation by the settlor of an intention to create the relationship and which subjects the person holding title to the property to equitable duties to deal with the property for the benefit of another person.[77] In our example of the settlor of the living trust that creates a bypass and marital trust, there are no new beneficiaries, although some may have changed from remainder to current beneficiaries, there are no new trustees or successors, no new property, and no new dispositive provisions. The only significant change is that the new trusts are irrevocable, which should not make a difference. Therefore, in this author's opinion, the new trusts in our example are simply a continuation of the old trust and did not acquire the oil and gas interests after January 1, 2004. Thus, the trustee may continue to allocate oil and gas receipts between income and principal in the same manner used by the trustee before January 1, 2004.

8. Unproductive Property

Former Texas Trust Code § 113.110 required the trustee to pay an income beneficiary the

[76] TEX PROP. CODE § 116.174(d).
[77] TEX PROP. CODE § 111.004(4).

"delayed income" from trust property that had been underproductive for more than one year. Underproductive was defined as producing an average annual net income of less than one percent. Upon a sale of that property, the income beneficiary was entitled to an amount as if the property had produced four percent a year simple interest during the allocation period.

However, now that the trustee may invest for total return and has the power to adjust between income and principal, the statute is no longer needed to protect the income beneficiary. Moreover, the former statute could have produced a windfall for the income beneficiary – giving him a reasonable share of the total income on a year by year basis plus a make-up carved out of the sale proceeds of the underproductive property. Such a result conflicts with the basic precept of the Uniform Prudent Investor Act to consider the trust as a whole and not on an asset by asset basis. However, the trustee is still under a basic duty to make trust property productive.

Therefore, TEX. PROP. CODE § 116.176 only allows a spouse who is a beneficiary of a *marital* deduction trust to require the trustee to either make the property productive, convert the property, or exercise the power to adjust under § 116.005(a) if needed to obtain the marital deduction. The trustee may decide which action or combination of actions to take.

B. Disbursements

1. Administrative, Judicial, and Other Expenses

Section 116.201(a)(1) requires the trustee to allocate one-half the fees of trustees and investment advisors to income and one-half to principal, regardless of the time and effort the trustee or the investment advisor spends on each component. It is difficult to avoid this mandate, unless the trustee exercises the power to adjust. Before it was amended in 2004, such fees were to be allocated on a "just and equitable" basis.

Similarly, § 116.201(a)(2) requires the trustee to allocate one-half the cost of accountings, judicial proceedings, and other matters involving *both* the income and remainder beneficiaries to income and one-half to principal. Prior to its amendment, these costs were allocated entirely to income. All other ordinary expenses are allocated to income.[78] These include expenses for the administration, management, or preservation of trust property and the distribution of income, including interest, ordinary repairs, regularly recurring taxes assessed against principal, and expenses of proceedings or other matters that concern primarily the income interest. Regularly recurring premiums on insurance covering the loss of an asset or the income from an asset are also charged to income.[79]

Disbursements charged to principal include the one-half not charged to income described above, trustees' fees charged as compensation for acceptance, distribution, termination, or preparing property for sale, debt payments, expenses of a proceeding that concerns primarily the principal, such as trust construction, insurance premiums not described above, such as life insurance premiums, estate taxes, and disbursements related to environmental matters.[80]

[78] TEX. PROP. CODE § 116.201(3).
[79] TEX. PROP. CODE § 116.201(4).
[80] TEX. PROP. CODE § 116.202(a).

There seems to be little flexibility in these expense allocation rules. A fiduciary with the power to adjust may exercise it to allocate expenses differently. The trustee should thoroughly document the reasons for his adjustment, make sure that it meets the statutory requirements for a power to adjust, and make it clear that the expense adjustment is an exercise of that power. Otherwise, a disgruntled beneficiary may claim that his deviation from the 50-50 rule violates the Texas UPIA and the trustee's duty of impartiality under TEX. PROP. CODE § 116.004(b).

In addition, a trustee holding certain business activities may also deviate from these rules by maintaining separate accounting records for the activity. This way the trustee can decide which "net cash receipts" are income or principal. But he may do so only if it is in the best interest of the beneficiaries. Eligible activities include retail, manufacturing, service, and other traditional business activities, the extraction of minerals, farming, management of rental properties, raising and selling animals, timber operations, and derivatives and options.[81]

2. Income Taxes

The UPIA has two sections that address the allocation of income taxes – TEX. PROP. CODE §§ 116.205 and 116.206. It is easy to confuse them because they appear similar. Section 116.205 addresses how to allocate taxes between income and principal receipts, including those from passthrough entities. It is mandatory. Section 116.206, on the other hand, addresses taxes that are not necessarily based on receipts and therefore potentially not covered by § 116.205. This includes taxes caused by elections, distributions, and ownership of passthrough entities. Thus, both sections cover the implication of passthrough entities that the trust owns.

The primary purpose of TEX. PROP. CODE § 116.205 is to allocate taxes between income and principal receipts to the extent thereof. It provides that taxes on income receipts are allocated to income and taxes on principal receipts are allocated to principal. If a trust owns a passthrough entity, the tax due on its share of the entity's taxable income must be paid from income to the extent that receipts from the entity are income and from principal to the extent that receipts from the entity are principal. In determining those taxes, the UPIA requires the trustee to consider that distributions to the beneficiary may be tax deductible to the trust. Because the trust's taxes and distributions to the beneficiary are interdependent, it requires an algebraic formula to determine the amount due a beneficiary when the trust owns a passthrough entity with undistributed taxable income.

a. Entity Distributes Less Than Enough to Pay the Trust's Taxes

In many situations the entity distributes little or nothing to its owners. Regardless, the trustee must report its full share of the entity's taxable income and pay the tax thereon. This can create cash flow problems for the trustee if the entity does not distribute enough to pay the trust's share of taxes on the entity's income. Consider the following example:

> **Example.** ABC Trust receives a K-1 from Partnership reflecting taxable income of $ 1 million and a $100,000 distribution from the partnership, which is allocated to income. The trust is in the 35 percent tax bracket.

[81] TEX. PROP. CODE § 153(c).

The trust's tax liability on $1,000,000 is $350,000. But the trust only received $100,000 from the entity, which is not enough to pay its tax obligation. The trustee must use the $100,000 to satisfy its tax obligation and the income beneficiary receives nothing.[82]

b. Entity Distributes More Than Enough to Pay the Trust's Taxes

Assume, however, that the entity distributes more than enough to pay taxes on its K-1 income. So the trustee has sufficient income receipts after paying its taxes to pay the beneficiary. But how much income does he owe the income beneficiary? Under TEX. PROP. CODE § 116.205, the trustee must deduct its tax on the entity's taxable income from the amount paid the income beneficiary. But its tax depends on the amount paid the beneficiary because distributions are deductible. Thus the calculation is interrelated, and must be solved either by trial and error or the following algebraic equation provided in the comments to the statute:[83]

$$D = (C-R*K)/(1-R)$$

D = Distribution to income beneficiary
C = Cash paid by the entity to the trust
R = tax rate on income
K = entity's K-1 taxable income

> **Example.** ABC Trust receives a K-1 from Partnership reflecting taxable income of $1 million. Partnership distributes $500,000 to the trust, which it represents to be income. The trust is in the 35 percent tax bracket.

In the example above, the partnership distribution exceeds the trust's $350,000 tax on the K-1 income by $150,000. But because the trust can deduct the $150,000 payment to the beneficiary, it must apply the algebraic formula to determine the amount owed the beneficiary so that after deducting the distribution, there is exactly enough to pay its tax on the remaining taxable income from the entity.

Taxable Income per K-1		1,000,000
Payment to beneficiary		230,769[84]
Trust Taxable Income		$ 769,231
35 percent tax	269,231	
Partnership Distribution		$ 500,000
Fiduciary's Tax Liability		(269,231)

[82] TEX. PROP. CODE § 116.205, cmt. Example.
[83] *Id.*
[84] D = (C-R*K)/(1-R) = (500,000 – 350,000)/(1 - .35) = $230,769. (D is the amount payable to the income beneficiary, K is the entity's K-1 taxable income, R is the trust ordinary tax rate, and C is the cash distributed by the entity).

Payable to the Beneficiary $ 230,769

The trustee allocates $269,231 of the entity's income receipts to pay the trustee's taxes. The income beneficiary also pays $80,769 [35% X $230,769] of personal income taxes when he reports the $230,769 on his individual income tax return, assuming he is in the 35 percent tax bracket. Thus the income beneficiary bore total taxes of $350,000 [$269,321 + $80,769], or the entire tax liability on the entity's $1,000,000 of Schedule K-1 income.[85]

When the entity distributes all of its taxable income, the formula isn't needed. The trustee may pay the entire distribution to the beneficiary because it will receive a distribution deduction exactly equal to the entity's taxable income, reducing its taxes to zero. Therefore, it need not withhold anything from the beneficiary to pay taxes.

> **Example.** ABC Trust receives a K-1 from Partnership reflecting taxable income of $1 million. Partnership distributes $1 million to the trust, which it represents to be income. The trust is in the 35 percent tax bracket. The trust may distribute the entire $1 million to the beneficiary because after deduction the $1 million distribution deduction, the trust's tax on the entity's taxable income is zero.

It does not matter whether the $1 million in the above example includes capital gains or not. The trust will still receive a distribution deduction for the entire $1 million paid to the beneficiary because capital gains from a partnership are included in DNI.[86]

Drafting attorneys should anticipate that a trust might own a significant interest in a partnership that may not distribute all its taxable income and clearly define how the income taxes on undistributed partnership income should be allocated if a different result is preferred. Alternatively, the trustee can exercise the power to adjust under TEX. PROP. CODE § 116.005 or the special power to adjust for taxes under § 116.206 as discussed below.

3. Adjustments Between Principal and Income Because of Taxes

The UPIA contains another rule that allows, and in some cases requires, the trustee to make equitable adjustments to offset the shifting tax burdens caused by a trustee's tax elections, decisions, distributions, transactions, and ownership of flow-through entities. This allows the trustee to adjust between income and principal to compensate for inequitable tax allocations arising from situations other than receipts. For example:[87]

● A fiduciary elects to deduct administration expenses that are paid from principal on an income tax return instead of on the estate tax return;

● A distribution of a principal asset to a trust or other beneficiary causes the taxable income of an estate or trust to be carried out to the distributee and relieves the persons who receive the income of any obligation to pay income tax on the income; or

[85] TEX. PROP. CODE § 116.205, cmt. Example 2.
[86] *See* discussion at Section XIII.B.
[87] TEX. PROP. CODE § 116.206, cmt.

● A trustee realizes a capital gain on the sale of a principal asset and pays a large state income tax on the gain, but under applicable federal income tax rules the trustee may not deduct the state income tax payment from the capital gain in calculating the trust's federal capital gain tax, and the income beneficiary receives the benefit of the deduction for state income tax paid on the capital gain.

These are just a few examples of when tax attributes created by one beneficiary class are economically borne by another class. While the classes appear to have been treated fairly economically, they may not have been fairly treated on an after-tax basis. Without an equitable adjustment standard, a beneficiary's only redress may be to seek court intervention for damages caused by the allocation. In the event that damages were awarded, the additional payments to the beneficiary could be treated as additional distributions, causing yet another set of tax calculations to equalize the equalizing distribution, and so on.[88]

At first the State Bar Committee felt that the equitable apportionment statute was unnecessary in Texas and so it was omitted from early versions of the proposed Texas Uniform Principal and Income Act. Mark Ascher, one of the principal drafters of the new Act, felt that there is "sufficient common law" (mostly in New York and California) to guide Texas fiduciaries on equitable adjustment issues and the statute would only complicate matters.[89] However, at the last minute, the State Bar Committee decided to add UPIA's equitable adjustment provision to the Texas Act. There is no corresponding section in the former Texas Trust Code.

Section 116.206 allows the fiduciary to make equitable adjustments between income and principal to compensate beneficiaries for a disproportionate sharing of a tax burden in the following situations:

a. Discretionary Adjustments

The fiduciary should exercise his equitable adjustment powers only to cure gross inequities caused by tax elections, transactions, or pass-through entities. No adjustment is needed when it is too complicated, expensive, time consuming, or when the potential benefits are minimal or conjectural. A reasonable effort should be made to balance fairness, tax savings, and simplicity in deciding whether to exercise any discretionary equitable adjustment powers.

i. Tax Elections and Decisions

The trustee makes many types of tax elections and decisions. For example, IRC § 642(g) allows the trustee to deduct certain administrative expenses either on the income tax return (benefiting the income beneficiary) or on the estate tax return (benefiting the principal beneficiary). If the trustee elects to deduct them on the estate tax return, the principal beneficiaries benefit because the estate taxes that they bear are reduced.[90] Section 116.206(a) permits trustees to reimburse the income beneficiaries to the extent they would have benefited

[88] Tech. Adv. Mem. 8501011 (Jun. 18, 1984); Tech. Adv. Mem. 8501084 (Sept. 28, 1984).

[89] Discussion with Mark L. Ascher, Sylvan Lang Professor in Law of Trusts, University of Texas at Austin School of Law (during State Bar UPIA Subcommittee meeting in Austin on December 14, 2001).

[90] TEX. PROP. CODE §§ 116.201(1) and 116.202(a)(6).

from the income tax deduction had the fees been deducted for income tax purposes.[91]

ii. Taxable Transactions or Distributions

A trustee may also make an adjustment to compensate for an income tax imposed as a result of a transaction involving or a distribution from the estate or trust.[92] For example, a trustee realizes a capital gain on the sale of a principal asset and pays a large state income tax on the gain.[93] However, the trustee may not deduct the state income tax payment from the capital gain allocated to principal in calculating the trust's federal capital gain tax. By default, the income beneficiary receives the tax benefit of deducting the state income taxes that are charged to the principal beneficiaries. Section 116.206(a)(2) allows an adjustment from income to principal to compensate for the tax savings the principal beneficiaries would have enjoyed had the deduction been allocated against capital gains.

iii. Pass-through Entities

Section 116.206(a)(3) allows the fiduciary to adjust between principal and income to offset the inequities caused by the trust's ownership of an entity whose taxable income is included in the taxable income of the estate, trust, or beneficiary, whether or not distributed.[94] Note that this power can be used to offset the tax allocations required under § 116.205 when the trust owns an interest in a passthrough entity, as discussed above.

This power may be used to transfer principal to income of a QSST when the QSST beneficiary pays the income tax on income from a Subchapter S corporation owned by the trust.[95] This power may also be used by the trustee of an intentionally defective grantor trust to compensate the grantor for income taxes paid on income of the grantor trust. The UPIA drafters considered whether to require a trustee to reimburse the settlor in these cases, but declined to do so.[96] They believed it would be difficult to establish a rule that applies both to trusts that intend the result and those that do not. A settlor that wants to authorize the trustee to reimburse the settlor for taxes paid on the trust's income should provide so in the trust agreement.

Revenue Ruling 2004-64 clarified that a grantor who is treated as the owner of a grantor trust that pays income taxes attributable to the inclusion of the trust's income, is not treated as making a gift of the tax to the trust beneficiaries. If the trust agreement requires the trustee to reimburse the grantor for the taxes payable by him on trust income, the full value of the trust's assets is includible in the grantor's gross estate under IRC § 2036(a)(1).[97] If, however, the trust's governing instrument or local law merely gives the trustee the discretion to reimburse the grantor for those taxes, the existence of that discretion, by itself (whether or not exercised) does not cause the value of the trusts' asses to be includible in the grantor's gross estate.

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[91] TEX. PROP. CODE § 116.206(a)(1).
[92] TEX. PROP. CODE § 116.206(a)(2).
[93] TEX. PROP. CODE § 116.206, cmt.
[94] TEX. PROP. CODE § 116.206(a)(3).
[95] *Id.*, Comments.
[96] TEX. PROP. CODE § 116.206, cmt.
[97] Rev. Rul. 2004-64, 2004-27 IRB 7 (July 1, 2004).

b. Mandatory Adjustments

If the amount of an estate tax marital or charitable contribution deduction is reduced because a fiduciary deducts 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 are increased and income taxes paid by an estate, trust, or beneficiary are decreased, each estate, trust, or beneficiary that benefits from the decrease in income tax must reimburse the principal from which the increase in estate tax is paid.[98] The total reimbursement must equal the increase in the estate tax to the extent that the principal used to pay the increase would have qualified for a marital deduction or charitable contribution deduction but for the payment.

The estate tax marital or charitable deduction is reduced only if estate transmission expenses (attorneys' fees, appraisal costs, executors' commissions, etc.) are paid from the marital and charitable shares.[99] Administrative (investment advisory fees, accounting fees, brokers' fees, etc.) can be paid from these shares without reducing the marital or charitable deduction. Therefore, if the fiduciary elects to deduct transmission expenses on the estate's Form 1041 instead of the Form 706, additional estate taxes may be due on account of the reduced marital deduction.[100] In this case the income beneficiaries obtain a tax benefit at the expense of the principal beneficiaries; and § 116.206(b) requires the income beneficiaries to reimburse the principal beneficiaries for the increased estate taxes.

VI. POWER TO ADJUST

The centerpiece, the most controversial, and least used provision of the Texas UPIA is the trustee's power to adjust between income and principal in § 116.005. This power is granted only to trustees, not to the personal representative of the estate.

A. What is the Power to Adjust?

After computing income and principal under the UPIA, the power to adjust allows the trustee to reallocate trust funds from principal to income, or vice versa as follows:

> Sec. 116.005. TRUSTEE'S POWER TO ADJUST. (a) A trustee may adjust between principal and income to the extent the trustee considers necessary if the trustee invests and manages trust assets as a prudent investor, the terms of the trust describe the amount that may or must be distributed to a beneficiary by referring to the trust's income, and the trustee determines, after applying the rules in § 116.004(a), that the trustee is unable to comply with § 116.004(b). The power to adjust conferred by this subsection includes the power to allocate all or part of a capital gain to trust income.

This power to adjust allows the trustee to invest for a maximum total return under the prudent investor rule without worrying about a specific level of dividend and interest income. For trustees that have a discretionary power to remedy income shortfalls by making principal

[98] TEX. PROP. CODE § 116.206(b).

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

[100] Reg. § 20.2056(b)-4(d) (as amended by T.D. 8846, Dec. 2, 1999).

distributions, the power to adjust is irrelevant. But, for "income rule" trusts, the power will have meaning.[101]

The power to adjust has been controversial because it is perceived to raise the investment standard for trustees too high. The natural result of this is more litigation against the trustee. A second concern is that the power to adjust is not uniformly granted. For example, trustees who are also beneficiaries of the trust may not exercise the power.[102] Because this provision clearly differentiates between corporate and family trustees, many feel that the UPIA unfairly discriminates against family trusts.

B. Capital Gains and the Power to Adjust

Texas added a small, but significant change to the Uniform Laws Commissioners Uniform Act which gives the trustee the power to add all or part of capital gain to income under the power to adjust. This allows capital gain to be included in the trust's distributable net income and carried out to the trust beneficiaries under Reg. § 1.643(a)-3(b).

Texas and South Dakota are the only states that give the trustee the discretion to characterize as capital gain any principal that has been reclassified to income under the power to adjust.[103] The discretion to allocate the trust's capital gains to income is critical under the IRC § 643 regulations in order to include the trust's capital gains in DNI. Note that the trustee's discretion to characterize principal as capital gains applies only to capital gains generated by the trust, and not to capital gains generated by a separate legal entity owned by the trust. Those capital gains are discussed later in this outline.

C. Conditions to Exercise of the Power

The Act provides three criteria for a trustee to exercise the power to adjust.[104] First, the trustee must be investing and managing the trust assets under the prudent investor rule. Second, the trust instrument must describe the amount that must be distributed to a beneficiary by referring to the trust's "income" in the sense of traditional trust income. And third, the trustee must determine that the trustee is unable to administer the trust or estate impartially, based on what is fair and reasonable to all beneficiaries, taking into consideration the settlor's written manifestation of intent to favor one or more of the beneficiaries.

1. Managing Assets Under the Prudent Investor Rule

The first of the three conditions is that the trustee must be investing and managing trust assets under the prudent investor rule. Texas enacted the Uniform Prudent Investor Act in 2003 and therefore all Texas trustees meet the first condition to use the power to adjust. That is, unless the trust instrument expressly eliminates or alters the prudent investor rule.[105]

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[101] "Income rule" trusts are those that define distributable amounts by reference to fiduciary accounting income.
[102] TEX. PROP. CODE § 116.005(c)(7).
[103] S.D. CODIFIED LAWS § 55-13A-104.
[104] TEX. PROP. CODE § 116.005(a).
[105] TEX. PROP. CODE § 117.003(b).

2. Trust Terms Must Expressly Refer to "Income"

The second condition required to use the power to adjust is met when the terms of the trust require all of the "income" to be distributed at regular intervals; or when the terms of the trust provide that the beneficiary shall receive the greater of the trust accounting income and a fixed dollar amount (an annuity), or of trust income and a fractional share of the value of the trust assets (a unitrust amount).[106] This condition will also be met if the trust grants the trustee discretion to distribute the trust's income to the beneficiary or to accumulate some or all of, but not more than the income.

c. Trustee Unable to Meet the Duty of Impartiality Otherwise

In order to meet the third condition to use the power to adjust, the trustee must first comply with any discretionary powers already given the trustee under the terms of the trust. The trustee must determine the extent to which the terms clearly manifest an intention by the settlor that the trustee may or must favor one or more of the beneficiaries. If the terms of the trust do not require partiality, the trustee must conclude that he or she is unable to administer the trust impartially. And to the extent that the terms of the trust do require the trustee to favor either the income or the remainder beneficiary, the trustee must conclude that he or she is unable to achieve the degree of partiality required or permitted. If the trustee comes to either conclusion, then the trustee may exercise the power to adjust.

<u>It cannot be overemphasized that the power to adjust does not empower the trustee to increase or decrease the degree of beneficial enjoyment to which a beneficiary is entitled under the terms of the trust. It may only be exercised to the extent that the investment policy selected by the trustee generates an insufficient amount of income for the income beneficiary</u>.[107]

3. Factors to Consider in Exercising the Power

Section 116.005(b) requires the trustee to consider several factors relevant to the trust and its beneficiaries in deciding whether and to what extent the power to adjust should be exercised. These factors act as checks on the power to adjust and include:

(1) the nature, purpose, and expected duration of the trust;

(2) the intent of the settlor;

(3) the identity and circumstances of the beneficiaries;

(4) the needs for liquidity, regularity of income, and preservation and appreciation of capital;

(5) the unique nature of the assets held in trust including the extent to which the assets may be used by the beneficiary and whether an asset was purchased by the trustee or acquired by the trustee;

(6) the net amount allocated to income and the increase and decrease in value of the

[106] TEX PROP. CODE § 116.005, cmt.
[107] TEX. PROP. CODE § 116.005,cmt.

principal assets;

(7) whether and to what extent the trustee may exercise discretion to invade principal;

(8) the actual and anticipated effects of inflation and deflation; and

(9) the anticipated tax consequences of an adjustment.

The Texas UPIA (and that of most other states) requires the trustee to consider all of these factors. Therefore, the settlor should clearly document his intent in the trust instrument to favor (or not) one or more classes of beneficiaries, and if so, how this should be accomplished. Such direction in the trust instrument, although rare and unexpected, would help the trustee to implement the power to adjust. The trustee should also document his consideration of all of the above factors. Such documentation will go a long way to minimizing litigation over faulty exercise of trustee discretion.

4. Limitations on the Power to Adjust

The power to adjust also has other limitations in addition to the three conditions discussed above. Section 116.005(c) provides eight situations in which the power to adjust is denied. These limitations are designed to preserve the tax benefits that may have been an important purpose for the creation of the trust, prevent adverse tax consequences, and to deny the power to certain types of trustees.

a. When the Power to Adjust is Denied

Specifically, a trustee may not make an adjustment:

(1) That reduces the actuarial value of the income interest in a trust to which a person transfers property with the intent to qualify for a gift tax exclusion;

(2) That changes the amount payable to a beneficiary as a fixed annuity or a fixed fraction of the value of the trust assets;

(3) From any amount that is permanently set aside for charitable purposes under a will or the terms of a trust unless both income and principal are so set aside;

(4) If possessing or exercising the power to make an adjustment causes an individual to be treated as the owner of all or part of the trust for income tax purposes, and the individual would not be treated as the owner if the trustee did not possess the power to make the adjustment;

(5) If possessing or exercising the power to make an adjustment causes all or a part of the trust assets to be included for estate tax purposes in the estate of an individual who has the power to remove a trustee or appoint a trustee, or both, and the assets would not be included in the estate of the individual if the trustee did not possess the power to make an adjustment;

(6) If the trustee is a beneficiary of the trust; or

(7) If the trustee is not a beneficiary, but the adjustment would benefit the trustee directly or indirectly.

Note that this power will generally be denied trustees of family trusts where the spouse or children are both the trustee and the beneficiary. However, this problem can be solved by appointing a co-trustee to exercise the power, as discussed below.

b. Application to Co-Trustees

If the UPIA denies the trustee one or more powers under § 116.005(c)(5)-(8) and there is more than one trustee, a co-trustee to whom the provision does not apply may make the adjustment unless the exercise of the power by the remaining trustee or trustees is not permitted by the terms of the trust.[108] Professor Jerry A. Kasner suggested that if the trustee is either a grantor or a beneficiary, a co-trustee or special trustee should be appointed whose only function is to exercise the power to adjust. He cautions that the governing instrument should provide that only the special trustee without the participation or approval of the interested trustee would exercise such a power.[109]

c. Release of a Power

A trustee may release the entire power under § 116.005(e) 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 will cause an adverse tax consequence. The release may be permanent or for a specified period, including a period measured by the life of an individual.

d. Trust Terms That Deny the Power

Terms of a trust that limit the power of a trustee to make an adjustment between principal and income do not affect the power to adjust under the UPIA unless it is clear from the terms of the trust that they are intended to deny the trustee the power to adjust conferred by the Act.[110]

5. Examples of the Power to Adjust

The following seven examples taken from the Comments to § 116.005 illustrate the application of the power to adjust. These examples illustrate the power is exercisable only in limited circumstances.

> Example (1) – T, a successor trustee, has received from the prior trustee a portfolio of financial assets invested 20 percent in stocks and 80 percent in bonds. The trust pays A income for life, with the remainder to B. Following the prudent investor rule, T determines that a portfolio with 50 percent in stocks and 50 percent in bonds is more reasonably suited

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[108] TEX. PROP. CODE § 116.005(d).

[109] Jerry A. Kasner, Capital Gains: A New Definition for Income and Principal?, TAX NOTES TODAY, Mar. 5, 2001 (commenting on the drafting implications of the new proposed regulations under IRC Sec. 643).

[110] TEX. PROP. CODE § 116.005(f).

to the trust. But T also determines that this approach will reduce the trust's dividend and interest income. After considering the factors in Section 104(b) [TEX. PROP. CODE § 116.005(b)], T may transfer cash from principal to income to the extent T considers it necessary to increase the amount distributed to the income beneficiary.

Example (2) – T is the trustee of a trust that requires the income to be paid to the settlor's son C for life, remainder to C's daughter D. In a period of very high inflation, T purchases bonds that pay double-digit interest and determines that a portion of the interest, which is allocated to income under Section 406 [TEX. PROP. CODE § 116.163] of this Act, is a return of capital. In consideration of the loss of value of principal due to inflation and other factors that T considers relevant, T may transfer part of the interest to principal.

Example (3) – T is the trustee of a trust that requires the income to be paid to the settlor's sister E for life, remainder to charity F. E is a retired schoolteacher who is single and has no children. E's social security income, pension, and savings exceed the amount she needs for her accustomed standard of living. The terms of the trust permit T to invade principal for E's health and to support her in her accustomed manner of living, but do not otherwise indicate that T should favor E or F. Applying the prudent investor rule, T determines that the trust assets should be invested entirely in growth stocks that produce very little income. Even though it is not necessary to invade principal to maintain E's accustomed standard of living, she is entitled to receive from the trust the degree of beneficial enjoyment normally accorded a person who is the sole income beneficiary of a trust. T may transfer cash from principal to income to provide her with that degree of enjoyment.

Example (4) – T is the trustee of an irrevocable trust that requires all of the income to be paid to G for life, remainder to H, and also gives T the power to invade principal for the benefit of G for "dire emergencies only." The trust limits the amount that T can distribute to G from principal during G's life to 6 percent of the trust's inception value. The trust's portfolio is invested initially 50 percent in stocks and 50 percent in bonds. But after the State adopts the prudent investor rule T determines that, to achieve suitable risk and return objectives for the trust, the assets should be invested 90 percent in stocks and 10 percent in bonds. This increases the trust's total return, but decreases its income. Thereafter, even though G does not experience a dire emergency, T may exercise the power to adjust under Section 104(a) [TEX. PROP. CODE § 116.005(a)] to the extent that the adjustment is from only the capital appreciation resulting from the change in the portfolio's asset allocation. If T cannot determine the extent to which capital appreciation resulted from the change in asset allocation or cannot substantiate the extent to which principal distributions to G for dire emergencies do not exceed the 6 percent limit, T may not exercise the power to adjust.

Example (5) – T is the trustee of a trust for the settlor's child. The trust owns marketable securities worth $600,000 and is the beneficiary of the settlor's IRA, which holds marketable securities worth $900,000. The trust receives the minimum required distribution (MRD) from the IRA and T allocates 10 percent of it to income under UPIA Section 409(c) [note the Texas version varies from the Act]. The total return on the IRA's assets exceeds the MRD, and the value of the IRA at the end of the year is more than its value at the beginning of the year. Factors that T may consider in determining whether to exercise the power to adjust and the extent to which an adjustment should be made to comply with Section 103(b) [TEX. PROP. CODE § 116.004(b)] include the total return from all of the trust's assets, those owned directly as well as those in the IRA, the extent to which the trust will owe income tax on the portion of the IRA distribution allocated to principal, and the extent to which the income beneficiary will owe income tax on the amount distributed to the income beneficiary.

Example (6) – T is the trustee of a trust whose portfolio includes a large parcel of undeveloped real estate. T pays property taxes on the parcel from income each year pursuant to Section 501(3) [TEX. PROP. CODE § 116.201(3)]. After considering the return from the trust's portfolio as a whole and other relevant factors described in Section 104(b) [TEX. PROP. CODE § 116.005(b)], T may exercise the power to adjust under Section 104(a) [TEX. PROP. CODE §116.005(a)] to transfer cash from principal to income in order to distribute to the income beneficiary an amount that T considers necessary to comply with Section 103(b) [TEX. PROP. CODE § 116.004(b)].

Example (7) – T is the trustee of a trust that owns a mutual fund sponsored by T. As the manager of the mutual fund, T charges the fund a management fee that reduces the amount available to distribute to the trust by $2,000. If the fee had been paid directly by the trust, one-half of the fee would have been paid from income under Section 501(1) [TEX. PROP. CODE § 116.201(1)] and the other one-half would have been paid from principal under Section 502(a)(1) [TEX. PROP. CODE § 116.202(a)(1)]. After considering the total return from the portfolio as a whole and other relevant factors described in Section 104(b) [TEX. PROP. CODE § 116.005(b)], T may exercise its power to adjust under Section 104(a) [TEX. PROP. CODE § 116.005(a)] by transferring $1,000, or half of the trust's proportionate share of the fee, from principal to income.

D. Challenging the Trustee's Exercise of the Power to Adjust

The Texas UPIA also provides some ground rules for when a trustee or beneficiary may seek judicial review of a trustee's decision to exercise or not exercise the power to adjust.[111] It applies an abuse of discretion standard to the trustee's decisions and may place the beneficiaries in a position they would have occupied if the trustee had not abused the discretion. But the statute makes it clear that neither the trustee nor the beneficiaries may run to the court for an advisory opinion on a proposed distribution any time they like.

1. Conditions

Because the State Bar UPIA drafting committee was concerned that the UPIA § 105 did not adequately protect the beneficiaries, it added some restrictions on judicial review in Texas. First, it requires the trustee to state in his petition for review the basis upon which he believes that a beneficiary will object. The failure of a beneficiary to sign a waiver or release is not reasonable grounds for a trustee to believe the beneficiary will object. Second, the court may appoint one or more guardians ad litem as it deems appropriate. Third, the trustee must advance reasonable attorney's fees, costs of the trustee and any beneficiary who retains counsel in the

[111] TEX. PROP. CODE § 116.006.

proceeding, and the guardian ad litem's fees. These fees and costs must be incident to the judicial determination and be advanced to any beneficiary who retains counsel, not just those who object to the trustee's proposed action.

2. Fees and Costs

The advancement of costs makes it possible for all interested parties to obtain representation in the proceeding, but it does not mean that the principal of the trust ultimately bears these costs. The court may award costs and fees against either the trust principal or income, against a beneficiary or his or her interest in the trust, or against the trustee in its individual capacity. A court may award costs against the trustee if the trustee's action or inaction would have resulted in an abuse of discretion or if the trustee did not have reasonable grounds for believing a beneficiary would object to the trustee's action.

VII. TEXAS UNITRUSTS

Late in the drafting stage, the Texas State Bar Committee inserted § 116.007 adding an optional unitrust for noncharitable trusts. This provision was designed to allow marital unitrusts (MUTs) to meet the mandatory income requirements for marital trusts set forth in Regulations § 20.2056(b)-5(f) and § 25.2523(e)-1(f). These regulations provide that a marital unitrust meets the mandatory income requirements and qualifies for the marital deduction if the trust income is determined under local law and meets the requirements under Reg. § 1.643(b)-1.[112] That is, a unitrust amount of no less than 3 percent and no more than 5 percent.

Section 116.007(b)(2) tracks the definition in Reg. § 1.643(b)-1(a) closely and provides that a Texas "unitrust amount" is:

> "…a distribution mandated by the terms of the trust in an amount equal to a fixed percentage of not less than three or more than five percent per year of the net fair market value of the trust's assets, valued at least annually."

A. Smoothing Rule

Then § 116.007(b)(2) adds a provision not found in the IRS proposed regulations. That is a "smoothing rule" whereby the unitrust amount may be determined by reference to the net fair market value of the trust's assets in one year or more than one year. For example, a three-year smoothing rule may allow a trustee of a 4 percent unitrust currently worth $1,000,000 to base the 4 percent on the average prior three years' trust net fair market value. If the trust was worth $600,000, $800,000, and $1,000,000 in each of the three prior years, the trustee may distribute currently 4 percent of the $800,000 average value.

B. Ordering Rule

In addition, § 116.007(d) provides for an ordering rule similar to the one in Example 11 of Reg. § 1.643(a)-3(e), where distributions come first out of ordinary income, then short-term capital gains, long-term capital gains, and finally principal. But § 116.007(d) is a default rule

[112] Reg. § 20.2056(b)-5(f) (Dec. 30, 2003).

only. The unitrust document may provide a different ordering rule. For example, it may provide that a unitrust payment carries out a prorata share of ordinary income and capital gains.

VIII. DISTRIBUTING CAPITAL GAINS

Nearly all state laws allocate capital gains from the sale or exchange of capital assets owned by the trust to corpus. As a consequence, they are also excluded from the trust's distributable net income (DNI), which is defined as:

> "the taxable income of the estate or trust computed with the following modifications –
>
> ***
>
> Gains from the sale or exchange of capital assets shall be excluded to the extent that such gains are allocated to corpus and are not (A) paid, credited, or required to be distributed to any beneficiary during the taxable year or (B) paid, permanently set aside, or to be used for the purposes specified in IRC § 642(c)."[113]

A. The General Rules

IRS regulations expand on that definition and provide that a trustee may include capital gains in DNI and carry it out to the beneficiaries only when the trustee: [114]

> a) has either the power to adjust or the discretion to distribute principal, *and* has discretion under local law or the governing instrument to deem all or part of such items as capital gains;
>
> b) is operating under a state unitrust statute that either provides an ordering rule or leaves it to the trustee's discretion whether to distribute capital gains;
>
> c) distributes trust property or sale proceeds thereof in full or partial termination of a beneficiary's interest; or
>
> d) uses the sales proceeds of specific assets to determine the amount required to be distributed to a beneficiary.

Thus, the regulations make it clear that a trustee may include capital gains in DNI only if *either* the state law or the governing instrument expressly authorizes the trustee to do so. Texas is the only state that expressly authorizes trustees to allocate capital gains to income under its power to adjust.[115] Other states have granted trustees the authority to distribute capital gains in a unitrust distribution, but not under a power to adjust. They provide an ordering rule under which ordinary and tax-exempt income flow out first, then short term capital gains, then long term capital gains, and then principal. This ordering rule was approved by the IRS in regulations.[116]

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[113] IRC § 643(a)(3).
[114] Reg. § 1.643(a)-3.
[115] TEX. PROP. CODE § 116.005.
[116] Reg. § 1.643(a)-3(e), Examples 11 and 13.

Query: Can a trust with capital gains from a pass-through entity include the entity's capital gains in DNI? The AICPA asked this very question in comments issued to the IRS in May 2001.[117] In response, the Preamble to the final regulations under IRC § 643(a) states:

> "One commentator requested examples of the effect on DNI of capital gains from a passthrough entity and income from a passthrough entity that is more or less than the trust accounting income from that entity. These issues are beyond the scope of this project."[118]

The IRS probably avoided this question because it knew that capital gains from partnership can be included in DNI. This is because DNI starts with taxable income of the trust (which includes partnership capital gains) and is reduced by "gains from the sale or exchange of capital assets…allocated to corpus" that are not paid to a beneficiary or permanently set aside for charity. Because partnership capital gains are not "gains from the sale or exchange of capital assets…allocated to corpus" they cannot be excluded from DNI.

Moreover, partnership capital gains arise from the sale of assets belonging to a separate legal entity. The trustee has no authority to allocate them to corpus. The trustee can only allocate *receipts* from the entity to corpus if they meet the definition of principal under the trust agreement or the state property or trust code.[119] The United States Court of Federal Claims addressed this very issue in *Crisp v. United States*.[120]

B. Capital Gains from Partnerships Owned by the Trust

In *Crisp v. United States*, the Caroline Hunt Trust Estate invested $5 million in a Texas limited partnership known as ZH Associates. The partnership generated a large amount of capital gains from sophisticated trading activities such as arbitrage and hedging. The Trust Agreement provided that the trustee may, at his or her discretion, distribute "net profits" or "net earnings" to Caroline Hunt, but may never distribute corpus:

> The Beneficiary may receive from time to time during the life of this trust, such portions of the net profits accruing from time to time to this Trust Estate, as the Trustee, acting with the advice and consent of the Advisory Board, may see fit to pay over and deliver to the Beneficiary. Net profits shall be determined by the annual audits as provided for herein, and the Trustee shall never in any event pay to the Beneficiary, during any one calendar year, any sum in excess of the Net Profits for the preceding calendar year.

[117] Tax Notes Today, 2001 TNT 97-26 (May 17, 2001) (Comments by the AICPA to Treasury regarding the proposed regulations to revise the definition of trust income under Section 643(b)).

[118] T.D. 9102.

[119] *See also* E. James Gamble, Trust Accounting and Income Taxes, AICPA Conference (June 2005), *available at* http://conferences.aicpa.org/materials/downloads/05%20EST%2044.pdf.

[120] Crisp v. United States, 34 Fed. Cl. 112 (1995).

The trustee, Don Crisp, treated the capital gains earned by the partnership and credited to the Trust’s account as “net profits,” included them in DNI, and carried them out to Caroline Hunt on the Trust’s Schedule K-1. The IRS challenged the inclusion of the partnership’s capital gains in the trust’s DNI as contrary to the Texas Trust Code, the trust instrument, and IRC § 643(a).

First the IRS argued that partnerships are not separate taxpayers under IRC §§ 701 and 702, but mere conduits through which tax items flow through to their partners. As a conduit, the partnership capital gains are corpus and should not be included in DNI. However, the Court noted that the Internal Revenue Code does not control the allocation between income and principal. Second, the IRS analogized partnership profits to capital gains from regulated investment companies (RICs) and mutual funds, which the Texas Trust Code allocates to corpus even though the trust does not hold title to the underlying securities. However, the Court was not persuaded by this argument either because ZH was neither a RIC nor a mutual fund.

Third, the IRS pointed out that the partnership capital gains fit squarely the definition of capital gains in the tax code and therefore they should be excluded from DNI under IRC § 643(a)(3). However, the Court reminded the IRS again that although the Internal Revenue Code affects the rate of tax on capital gains, it does not control whether they are income or principal. Finally, the IRS argued that allowing the trustee to treat partnership capital gains as income permitted him to use the partnership form to convert corpus into income. However, the Court pointed out that trustees can do this anyway simply by choosing whether to invest in income or growth assets. Further, the trustee was merely exercising the discretion granted him in the trust instrument to choose among various business structures.

In sum, the Court held that the partnership profits are not corpus under either the trust agreement or state law because the trust did not acquire the securities. Rather, the partnership, a distinct legal entity acquired the securities.[121] It also gave weight to the fact that the trustee hired a national accounting firm to audit the trust and they determined that its partnership profits were allocating its profits to income did not jeopardize the interests of the remaindermen. But even if the trustee’s allocation favored the income beneficiary, the facts indicate that the settlors intended that result. Therefore, the capital gains from the partnership constituted trust income.

Even though *Crisp* was decided before the final § 643 regulations and the adoption of the Uniform Principal and Income Act (1997), its holding is still sound because partnership capital gains are not “gains from the sale or exchange of capital assets…allocated to corpus” under either state law, the trust instrument, or IRC § 643(a).

C. Carrying Out Capital Gains from a Unitrust

Capital gains can also be carried out with a unitrust payment. Most state unitrust statutes provide an ordering rule under which ordinary and tax-exempt income flow out first, then short term capital gains, then long term capital gains, and then principal. This order follows the examples in the regulations.[122] The ordering rules in the regulations are safe harbors. As such,

[121] Crisp v. United States, 34 Fed. Cl. 112 at 118-120.
[122] Reg. § 1.643(a)-3(e), Examples 11 and 13.

they do not preclude other means of distributing capital gains, especially if the trust instrument requires a particular method. The regulations do, however, require that if the trustee has discretion, he exercise that discretion *consistently* in allocating capital gains to income.[123] Presumably this means that once the trustee picks an allocation method, he stick with it.

However, the trustee may wish to allocate taxable income under a different ordering rule than the regulations illustrate. For example, he may wish to allocate capital gains in the same proportion as the trust's capital gains bears to its total taxable income for the year. So if 80 percent of a unitrust's taxable income consists of capital gains, the trustee might allocate 80 percent of the unitrust payment to capital gains. It is not clear whether the IRS will recognize this as a valid means of determining DNI under § 643. But regardless of whether the IRS recognizes the allocation as valid, it should not adversely affect the trust's qualification as a marital trust. The regulations under § 2056 require only that the unitrust payment or the trustee's power to adjust meet the requirements of Reg. § 1.642(b)-1, which addresses the *amount* and not the character of the income distributed.[124]

D. 65 Day Elections

A trustee may elect under IRC § 663(b) to treat all or a portion of distributions made during the first 65 days of a trust's tax year as having been made on the last day of the previous tax year. This is purely a tax election and has no effect on the trustee's classification of income or principal on its books and records. The election is limited to the trust's income under Reg. § 1.643(b)-1 or the distributable net income (DNI) if greater.[125] This election is primarily made by complex trusts because simple trusts receive a distribution deduction for income they are required to distribute, limited to DNI, whether or not distributions are in fact made.[126]

If a complex trust describes the amount of income that may be distributed by referring to the trust's income, its trustee may have the power to adjust and allocate capital gains to income. If the trustee makes a 65 day election, it should apply to the capital gains as well as ordinary income. The AICPA asked the IRS to verify this result in comments on the final regulations.[127] However, the IRS did not address this point. They informally indicated that their failure to address the issue was not a matter of doubt that the 65 day election could apply to capital gains, but was rather a need to get the regulations finalized after nearly three years of delay following the proposed regulations.

Assuming the 65 day election applies to capital gain distributions, it can have a significant impact.

> **Example.** Assume the trustee of a complex trust may distribute up to, but no more than, the trust's income each year. In Year 1 the trustee distributed all trust's accounting income

[123] Reg. § 1.643(a)-3(b)(1).
[124] Reg. § 1.2056(b)-7(d)(1).
[125] Reg. § 1.643(b)-1(a)(2) (as amended by T.D. 7204, Aug. 24, 1972).
[126] Reg. § 1.651(a)-1(b).
[127] AICPA Comments, Proposed Regulations Under IRC Section 643 Regulations Regarding the Definition of Income, TAX NOTES TODAY, 2001-TNT 97-26 (May 18, 2001).

> and carried out all the trust's DNI. In addition, the trust has an undistributed $100,000 capital gain and the beneficiary personally incurred a $100,000 capital loss during the year. Within the first 65 days of Year 2 the trustee makes a discretionary distribution intended to reclassify Year 1 principal to income.

The trustee should be able to elect under IRC § 663(b) to treat all or part of it as though it occurred in Year 1 as long as local law or the trust instrument gives the trustee the authority to deem discretionary distributions to be made from capital gains. Because the beneficiary has a capital loss, the distribution is effectively tax free to the beneficiary.

The planning implications are daunting. Trustees anticipating this election should continue the practice of making "protective distributions" during the first 65 days of a tax year. In fact, trustees that reallocate principal to capital gains should be under a duty to make those distributions within 65 days along with a timely § 663(b) election in order to avoid adverse tax consequences to the beneficiary. CPAs considering this election need to be aware that it may now carry out capital gains, to the extent the trustee has exercised discretionary authority to reallocate principal to income and has the authority to deem those distributions to be made from capital gains. Trustees and tax preparers need to consider both the beneficiary's capital gain/loss position as well as his ordinary income tax bracket before making the 65 day election.

IX. FIDUCIARY ACCOUNTINGS

When an accountant is hired to prepare a "fiduciary accounting," there is usually a very specific purpose. It may be as simple as wanting to provide the beneficiaries with current information. Or it may be in response to a demand for an accounting or a pending lawsuit. In any event "accounting" is a term of art, more likely to be defined by the trustee's purpose than by the accounting profession. The first thing the accountant should do is ask the following questions:

1. What is the purpose of the accounting?

2. Who are the users of the accounting?

3. Is there a specific format the accounting should conform to?

A. Duty to Inform

The trustee who requests an accounting may simply be trying to keep the beneficiaries informed. Prior to 2007, TEX. PROP. CODE § 113.060 required a trustee of an existing trust or one created on or after January 1, 2006 to keep the beneficiary reasonably informed concerning the administration of the trust and the material facts necessary to protect their interests. However, that section was repealed effective June 16, 2007. Nonetheless, it did not repeal any common law duty to keep a beneficiary informed, which continues in effect. In addition, the terms of an irrevocable trust may not limit the trustee's common law duty to keep a beneficiary who is 25 years old informed at any time during which the beneficiary is entitled or permitted to receive distributions from the trust or would receive a distribution if the trust were terminated.[128]

[128] TEX. PROP. CODE § 111.0035(c).

Therefore, a fiduciary accounting may be provided simply to keep the beneficiaries reasonably informed.

B. Duty to Account

A trustee also has a duty to respond to a beneficiary who demands a written statement of accounts covering all transactions since the last accounting, or since the creation of the trust, whichever is later.[129] Beneficiary means any "person for whose benefit property is held in trust, regardless of the nature of the interest."[130] An interested person may also sue to compel the trustee to deliver an accounting to the interested person, if the nature of his interest is sufficient to convince the court.[131] Interested person is broadly defined to include "a trustee, beneficiary, or any other person having an interest in or claim against the trust or any person who is affected by the administration of the trust."[132]

Although the trust instrument may limit the duty to account, an irrevocable trust instrument may not limit the duty with respect to a beneficiary who is entitled or permitted to receive distributions from the trust or would receive a distribution if it were terminated.[133] If the trustee fails or refuses to deliver the statement within 90 days after the trustee receives the demand, or after a longer period ordered by a court, a beneficiary may sue to compel the trustee to deliver the statement to all the beneficiaries. The court may also require on its own that the trustee deliver an accounting to the beneficiaries. However, the trustee is not required to account more frequently than once every 12 months, unless the court requires it.

If a beneficiary is successful in the suit to compel an accounting, the court may award all or part of the court costs and all of the suing beneficiary's reasonable and necessary attorney's fees and costs against the trustee in his individual capacity or in his capacity as trustee. Failure to deliver an accounting can also be grounds for fining or removing a trustee or executor.[134]

IX. COMMUNITY PROPERTY AND TRUST INCOME

The Uniform Principal and Income Act also plays a vital role in determining whether trust distributions are separate or community property. This determination is important in dividing marital property in divorce actions a well as reporting the decedent's property as part of his gross estate for federal estate tax purposes. For many years it was unclear whether trust income received during marriage was separate or community property. Case law varied greatly depending on whether the trust was revocable or irrevocable, the beneficiary was also the grantor or trustee, whether distributions were mandatory or discretionary, and so on. In general, distributions were community property if the receiving spouse maintained an interest in or was

[129] TEX. PROP. CODE § 113.151(a).

[130] TEX. PROP. CODE § 111.004(2).

[131] TEX. PROP. CODE § 113.151(b).

[132] TEX. PROP. CODE § 111.004(7).

[133] TEX. PROP. CODE § 111.0035(b)(4).

[134] TEX. PROP. CODE § 113.082(a)(3); TEX. PROB. CODE §§ 149A, 149B, 222(b)(2).

entitled to the trust corpus.[135] But no court had decided what the legal standard should be for determining whether a spouse has an interest in trust corpus.

The landscape changed in 2009 with *Sharma v. Routh*.[136] Timothy Sharma was seeking a divorce from Lisa Routh, to whom he had been married for just a few months. Lisa was claiming as community property her share of income received during their marriage from two trusts under the will of Timothy's first wife, Dr. Alice Sharma. Alice's will had created a typical Marital Trust and Family Trust. The trusts owned approximately $35 million of installment notes from the sale of real estate. Both trusts named Timothy as trustee and income beneficiary, and charitable foundations as remainder beneficiaries. The trial court had held that distributions from both trusts were community property, and awarded Lisa Routh half of the income earned during the period of their short marriage, or $1.9 million. Timothy Sharma appealed.

The 14th Court of Appeals, Houston examined prior case law and determined that distributions from an irrevocable testamentary or inter vivos trust to a married recipient who has no present possessory right to trust corpus are separate property because the income itself was the gift. Moreover, the distributions were not income from separate property because the beneficiary does not own the trust corpus. However, trust distributions would be community property if the spouse has received or is entitled to receive mandatory distributions of trust corpus. Timothy Sharma had a right to distributions of corpus "as are necessary, when added to the funds reasonably available to him from all other sources known to the trustee to provide for his health, support, and maintenance in order to maintain him, to the extent reasonably possible, in accordance with the standard of living to which he is accustomed at the time of my [Alice's] death," which the court referred to a s a "Support Provision." It is also known as an ascertainable standard, or HEMS provision, which prevents the trustee/beneficiary from having a general power of appointment over the trust property..

The appeal court held that Timothy's right to corpus distributions under the Support Provision did not constitute a "present possessory right" or mandatory right to any part of the corpus because he did not meet the Support Provision and had never taken any distributions pursuant to it. However, on a few occasions Timothy had erroneously deposited trust principal in his own bank account, but later repaid it to the trust. The court noted that his erroneous deposit did not constitute a "present possessory right" or mandatory distribution of corpus because he was never entitled to it. However, if Timothy had made corpus distributions based on a determination that he met the Support Provision, thus determining that they were required by the trust document, the court would likely have found that he had a present possessory right to the corpus and the distributions would have been community property.

Because Timothy had no right to mandatory distributions of corpus, the court found that income distributions from the Marital and the Bypass Trusts were his separate property and

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[135] Ridgell v. Ridgell, 960 S.W.2d 144 (1997); In re Marriage of Long, 542 S.W.2d 712 (1976); Mercantile Nat'l Bank at Dallas v. Wilson, 279 S.W.2d 650 (1955) (trust distributions are community property if married beneficiary is entitled to or maintains an interest in trust corpus); *But see* Cleaver v. Cleaver, 935 S.W.2d 491 (1996) (trust income is separate property where the trust prohibited corpus distributions).

[136] Sharma v. Routh, 302 S.W.3d 355 (2009).

reversed the trial court's decision. Therefore, it is important to distinguish whether a trustee has made principal distributions, and if so, whether the trustee was required to do so. This underlines the importance of determining whether a distribution is income or principal under the UPIA. It also demonstrates the importance of determining whether corpus distributions are *required* to be made. If the trustee has a discretionary right to distribute corpus, this would not constitute a present possessory interest because it is not a right to receive mandatory corpus distributions. If, however, the trustee must distribute principal under a certain standard, the beneficiary will likely have a present possessory right to the corpus and thus distributions of trust income will be community property. This case highlights the importance of reading the trust instrument thoroughly and documenting whether the beneficiary received corpus distributions.