

<p>Article 7.Part 9. SC Uniform Principal and Income Act and Prudent Investor Act</p>	<p>Article 7.Part 9. SC Uniform Principal and Income Act</p>
<p>GENERAL SOUTH CAROLINA COMMENT</p> <p>The South Carolina Trust Code retains and incorporates at SCTC Sections 62-7-901 through 932 the provisions of the South Carolina Uniform Principal and Income Act formerly found at South Carolina Probate Code Sections 62-7-401 through 62-7-432. Any reference elsewhere in the South Carolina Code to former SCPC Sections 62-7-401 through 62-7-432 should now refer to SCTC Sections 62-7-901 through 62-7-932.</p> <p>With a few exceptions, the South Carolina Trust Code retains and incorporates at SCTC Section 62-7-933 the provisions of the South Carolina Uniform Prudent Investor Act formerly found at South Carolina Probate Code Section 62-7-302. The exceptions result from the deletion of several subsections of former SCPC Section 62-7-302 that are duplicative of provisions in the South Carolina Trust Code: former SCPC Section 62-7-302(C)(6), (F), and (H). The correlative provisions of the South Carolina Trust Code, which govern investment, administration, and distribution of trust property, are broader in perspective than the deleted SCPC subsections, which governed only investment and management of trust property. Any reference elsewhere in the South Carolina Code to former SCPC Section 62-7-302 should now refer to SCTC Section 62-7-933. SCTC Section 62-7-933(C)(5)(c) retains and incorporates former South Carolina Probate Code Section 62-7-602.</p>	<p>PREFATORY NOTE</p> <p>In 2001 South Carolina enacted as part of its version of the Uniform Probate Code (“the South Carolina Probate Code or SCPC”) the South Carolina Uniform Principal and Income Act, Sections 62-7-401 through 62-7-432 (SCUP &IA). This is South Carolina’s version of the Uniform Principal and Income Act which had been recommended in 1997 by the Uniform Law Commissioners (ULC) for enactment in all the states. ULC’s 1997 Uniform Principal and Income Act revised its original 1931 Uniform Principal and Income act (the 1931 Act) and its 1962 Revised Uniform Principal and Income Act (the 1962 Act). Likewise, 2001 SCUP&IA revised South Carolina’s 1963 “Revised Uniform Principal and Income Act”, Sections 62-7-401 through 62-7-421 (the 1963 SC Act). South Carolina did not enact ULC’s 1931 Act. When in 2005 South Carolina enacted its version of ULC’s recommended 2000 Uniform Trust Code as the South Carolina Trust Code, SC Code Title 62, Article 7 (SCTC), SCUP&IA was retained, re-numbered and incorporated at SCTC Sections 62-7-901 through 932. Any reference elsewhere in the South Carolina Code to former SCPC Sections 62-7-401 through 432 should now refer to SCTC Sections 62-7-901 through 932.</p> <p>The 1997 revision by ULC of its original 1931 Uniform Principal and Income Act (the 1931 Act) and its 1962 Revised Uniform Principal and Income Act (the 1962 Act) and the subsequent 2001 revision by South Carolina of its 1963 Revised Uniform Principal and Income Act (1963 SC Act) had two purposes:</p> <p>(1) One purpose was to revise the 1931 and 1962 Acts and the 1963 SC Act, respectively. Revision was needed to support the now widespread use of the revocable living trust as a will substitute by the 1990s, to change the rules in those Acts that experience had shown needed to be changed, and to establish new rules to</p>

cover situations not provided for in the old Acts, including rules that apply to financial instruments invented since 1962.

(2) The other purpose was to provide a means for implementing the transition to an investment regime based on principles embodied in the Uniform Prudent Investor Act, especially the principle of investing for total return rather than a certain level of “income” as traditionally perceived in terms of interest, dividends, and rents.

Revision of the 1931 and 1962 Acts and the corresponding 1963 SC Act.

The prior Acts and revision of those Acts dealt with four questions affecting the rights of beneficiaries:

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

(2) When an income interest in a trust begins (i.e., when a person who creates the trust dies or when she transfers property to a trust during life), what property is principal that will eventually go to the remainder beneficiaries and what is income?

(3) When an income interest ends, who gets the income that has been received but not distributed, or that is due but not yet collected, or that has accrued but is not yet due?

(4) After an income interest begins and before it ends, how should its receipts and disbursements be allocated to or between principal and income?

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

New rules. Issues addressed by some of the more significant new rules include:

(1) The application of the probate administration rules to revocable living trusts after the settlor’s death and to other terminating trusts. Sections 62-7-905 through 909.

(2) The payment of interest or some other amount on the delayed payment of an outright pecuniary gift that is made pursuant to a trust agreement instead of a will when the agreement does not provide for such a payment. Section 62-7-905(3).

(3) The allocation of net income from partnership interests acquired by the trustee other than from a decedent (the old Acts deal only with partnership interests acquired from a decedent). Section 62-7-910.

(4) An “unincorporated entity” concept has been introduced to deal with businesses operated by a trustee, including farming and livestock operations, and investment activities in rental real estate, natural resources, timber, and derivatives. Section 62-7-912.

(5) The allocation of receipts from discount obligations such as zero-coupon bonds. Section 62-7-915(B).

(6) The allocation of net income from harvesting and selling timber between principal and income. Section 62-7-921.

(7) The allocation between principal and income of receipts from derivatives, options, and asset-backed securities. Sections 62-7-923 and 924.

(8) Disbursements made because of environmental laws. Section 62-7-926(A)(7).

(9) Income tax obligations resulting from the ownership of S corporation stock and interests in partnerships. Section 62-7-929.

(10) The power to make adjustments between principal and income to correct inequities caused by tax elections or peculiarities in the way the fiduciary income tax rules apply. Section 62-7-930.

Clarifications and changes in existing rules.

A number of matters provided for in the prior Acts have been changed or clarified in this revision, including the following:

(1) An income beneficiary’s estate will be entitled to receive only net income actually received by a trust before the beneficiary’s death and not items of accrued income. Section

62-7-909.

(2) Income from a partnership is based on actual distributions from the partnership, in the same manner as corporate distributions. Section 62-7-910.

(3) Distributions from corporations and partnerships that exceed 20% of the entity's gross assets will be principal whether or not intended by the entity to be a partial liquidation. Section 62-7-910 (D)(2).

(4) Deferred compensation is dealt with in greater detail in a separate section. Section 62-7-918.

(5) The 1962 Act rule for "property subject to depletion," (patents, copyrights, royalties, and the like), which provides that a trustee may allocate up to 5% of the asset's inventory value to income and the balance to principal, has been replaced by a rule that allocates 90% of the amounts received to principal and the balance to income. Section 62-7-919.

(6) The percentage used to allocate amounts received from oil and gas has been changed - 90% of those receipts are allocated to principal and the balance to income. Section 62-7-920.

(7) The unproductive property rule has been eliminated for trusts other than marital deduction trusts. Section 62-7-922.

(8) Charging depreciation against income is no longer mandatory, and is left to the discretion of the trustee. Section 62-7-927.

Coordination with the Uniform Prudent Investor Act

The law of trust investment has been modernized. See Uniform Prudent Investor Act (1994); Restatement (Third) of Trusts: Prudent Investor Rule (1992) (hereinafter Restatement of Trusts 3d: Prudent Investor Rule). Now it is time to update the principal and income allocation rules so the two bodies of doctrine can work well together. This revision deals conservatively with the tension between modern investment theory and traditional income allocation. The starting point is to use the traditional system. If prudent investing of all

the assets in a trust viewed as a portfolio and traditional allocation effectuate the intent of the settlor, then nothing need be done. The Act, however, helps the trustee who has made a prudent, modern portfolio-based investment decision that has the initial effect of skewing return from all the assets under management, viewed as a portfolio, as between income and principal beneficiaries. The Act gives that trustee a power to reallocate the portfolio return suitably. To leave a trustee constrained by the traditional system would inhibit the trustee's ability to fully implement modern portfolio theory. [Since the early 1990s when this Prefatory Note and the following Comments were prepared by ULC, Restatement of Trusts 3d has progressed significantly as reported in the Forenote to Chapter 17 of what is now cited as "Restatement Third, Trusts":

The contents of this Chapter (Introduction and Sections 90-92) were approved at the American Law Institute's 1990 Annual Meeting and were originally published as Sections 227-229 of Restatement Third, Trusts (Prudent Investor Rule) in 1992 [referred to throughout this SCUP&IA Prefatory Note and the following Comments as either "Restatement of Trusts 3d; Prudent Investor Rule" or simply "1992 Restatement"]

Therefore, appropriate reference to Chapter 17 (Introduction and Sections 90-92) of Restatement Third, Trusts is suggested.]

As to modern investing see, e.g., the Preface to, terms of, and Comments to the Uniform Prudent Investor Act (1994); the discussion and reporter's note by Edward C. Halbach, Jr. in Restatement of Trusts 3d: Prudent Investor Rule; John H. Langbein, The Uniform Prudent Investor Act and the Future of Trust Investing, 81 Iowa L. Rev. 641 (1996); Bevis Longstreth, Modern Investment Management and the Prudent Man Rule (1986); John H. Langbein & Richard A. Posner, The Revolution in Trust Investment Law, 62 A.B.A.J. 887 (1976); and

Jeffrey N. Gordon, The Puzzling Persistence of the Constrained Prudent Man Rule, 62 N.Y.U. L. Rev. 52 (1987). See also R.A. Brearly, An Introduction to Risk and Return from Common Stocks (2d ed. 1983); Jonathan R. Macey, An Introduction to Modern Financial Theory (2d ed. 1998). As to the need for principal and income reform see, e.g., Joel C. Dobris, Real Return, Modern Portfolio Theory and College, University and Foundation Decisions on Annual Spending From Endowments: A Visit to the World of Spending Rules, 28 Real Prop., Prob., & Tr. J. 49 (1993); Joel C. Dobris, The Probate World at the End of the Century: Is a New Principal and Income Act in Your Future?, 28 Real Prop., Prob., & Tr. J. 393 (1993); and Kenneth L. Hirsch, Inflation and the Law of Trusts, 18 Real Prop., Prob., & Tr. J. 601 (1983). See also, Jerold I. Horn, The Prudent Investor Rule B, Impact on Drafting and Administration of Trusts, 20 ACTEC Notes 26 (Summer 1994).

SECTION 62-7-901. Short title.

Sections 62-7-901 through 62-7-932 of this Part may be cited as the South Carolina Uniform Principal and Income Act.

SECTION 62-7-902. Definitions.

As used in this part:

(1) "Accounting period" means a calendar year unless another twelve-month period is selected by a fiduciary. The term includes a portion of a calendar year or other twelve-month period that begins when an income interest begins or ends when an income interest ends.

(2) "Beneficiary" includes, in the case of a decedent's estate, an heir, legatee, and devisee and, in the case of a trust, an income beneficiary and a remainder beneficiary.

(3) "Fiduciary" means a personal representative or a trustee. The term includes an executor, administrator, successor personal

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(2) 'Beneficiary' includes, in the case of a decedent's estate, an heir, legatee, and devisee and, in the case of a trust, an income beneficiary and a remainder beneficiary.

(3) 'Fiduciary' means a personal representative or a trustee. The term includes an executor, administrator, successor personal

<p>representative, special administrator, and a person performing substantially the same function.</p> <p>(4) “Income” means money or property that a fiduciary receives as current return from a principal asset. The term includes a portion of receipts from a sale, exchange, or liquidation of a principal asset, to the extent provided in Section 62-7-910 through Section 62-7-924.</p> <p>(5) “Income beneficiary” means a person to whom net income of a trust is or may be payable.</p> <p>(6) “Income interest” means the right of an income beneficiary to receive all or part of net income, whether the terms of the trust require it to be distributed or authorize it to be distributed in the trustee’s discretion.</p> <p>(7) “Mandatory income interest” means the right of an income beneficiary to receive net income that the terms of the trust require the fiduciary to distribute.</p> <p>(8) “Net income” means the total receipts allocated to income during an accounting period minus the disbursements made from income during the period, plus or minus transfers under this part to or from income during the period.</p> <p>(9) “Person” means any individual, corporation, business trust, estate, trust, partnership, limited liability company, association, joint venture, or government, governmental subdivision, agency, or instrumentality; or public corporation, or other legal or commercial entity.</p> <p>(10) “Principal” means property held in trust for distribution to a remainder beneficiary when the trust terminates.</p> <p>(11) “Remainder beneficiary” means a person entitled to receive principal when an income interest ends.</p> <p>(12) “Terms of a trust” means the manifestation of the intent of a settlor or decedent with respect to the trust, expressed in a manner that admits of its proof in a judicial proceeding, whether by written or</p>	<p>representative, special administrator, and a person performing substantially the same function.</p> <p>(4) ‘Income’ means money or property that a fiduciary receives as current return from a principal asset. The term includes a portion of receipts from a sale, exchange, or liquidation of a principal asset, to the extent provided in Section 62-7-910 through Section 62-7-924.</p> <p>(5) ‘Income beneficiary’ means a person to whom net income of a trust is or may be payable.</p> <p>(6) ‘Income interest’ means the right of an income beneficiary to receive all or part of net income, whether the terms of the trust require it to be distributed or authorize it to be distributed in the trustee’s discretion.</p> <p>(7) ‘Mandatory income interest’ means the right of an income beneficiary to receive net income that the terms of the trust require the fiduciary to distribute.</p> <p>(8) ‘Net income’ means the total receipts allocated to income during an accounting period minus the disbursements made from income during the period, plus or minus transfers under this part <u>the South Carolina Uniform Principal and Income Act</u> to or from income during the period.</p> <p>(9) ‘Person’ means any individual, corporation, business trust, estate, trust, partnership, limited liability company, association, joint venture, or government, governmental subdivision, agency, or instrumentality; or public corporation, or other legal or commercial entity.</p> <p>(10) ‘Principal’ means property held in trust for distribution to a remainder beneficiary when the trust terminates.</p> <p>(11) ‘Remainder beneficiary’ means a person entitled to receive principal when an income interest ends.</p> <p>(12) ‘Terms of a trust’ means the manifestation of the intent of a settlor or decedent with respect to the trust, expressed in a manner that admits of its proof in a judicial proceeding, whether by written or spoken words</p>
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(13) “Trustee” includes an original, additional, or successor trustee, whether or not appointed or confirmed by a court.

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REPORTER’S COMMENT

“Income beneficiary.” The definitions of income beneficiary (Section 62-7-902(5)) and income interest (Section 62-7-902(6)) cover both mandatory and discretionary beneficiaries and interests. There are no definitions for “discretionary income beneficiary” or “discretionary income interest” because those terms are not used in the Act.

“Inventory value.” There is no definition for inventory value in this Act because the provisions in which that term was used in the 1962 Act and the 1963 SC Act have either been eliminated (in the case of the underproductive property provision) or changed in a way that eliminates the need for the term (in the case of bonds and other money obligations, property subject to depletion, and the method for determining entitlement to income distributed from a probate estate).

“Net income.” The reference to “transfers under this Act to or from income” means transfers made under Sections 62-7-904(A), 921(A), 926(B), 927(B), 904(A) and 930.

“Terms of a trust.” This term was chosen in preference to “terms of the trust instrument” (the phrase used in the 1962 Act and the 1963 SC Act) to make it clear that the Act applies to oral trusts as well as those whose terms are expressed in written documents. The definition is based on the (1959) and the Restatement (Second) of Trusts Sec. 4 (Tent. Draft No. 1, 1996). Constructional preferences or rules would also apply, if necessary, to determine the terms of the trust.

SECTION 62-7-903. Allocation of receipts and disbursements.

(A) In allocating receipts and disbursements to or between principal and income, and with respect to any matter within the scope of Sections 62-7-905 through 62-7-909, a fiduciary:

(1) shall administer a trust or estate in accordance with the terms of the trust or the will, even if there is a different provision in this part;

(2) may administer a trust or estate by the exercise of a discretionary power of administration given to the fiduciary by the terms of the trust or the will, even if the exercise of the power produces a result different from a result required or permitted by this part;

(3) shall administer a trust or estate in accordance with this part if the terms of the trust or the will do not contain a different provision or do not give the fiduciary a discretionary power of administration; and

(4) shall add a receipt or charge a disbursement to principal to the extent that the terms of the trust and this part do not provide a rule for allocating the receipt or disbursement to or between principal and income.

(B) In exercising the power to adjust pursuant to Section 62-7-904(A) or a discretionary power of administration regarding a matter within the scope of this part, whether granted by the terms of a trust, a will, or this part, a fiduciary shall administer a trust or estate impartially, based on what is fair and reasonable to all of the beneficiaries, except to the extent that the terms of the trust or the will clearly manifest an intention that the fiduciary shall or may favor one or more of the beneficiaries. A determination in accordance with this part is presumed to be fair and reasonable to all of the beneficiaries.

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(1) shall administer a trust or estate in accordance with the terms of the trust or the will, even if there is a different provision in ~~this part~~ the South Carolina Uniform Principal and Income Act;

(2) may administer a trust or estate by the exercise of a discretionary power of administration given to the fiduciary by the terms of the trust or the will, even if the exercise of the power produces a result different from a result required or permitted by ~~this part~~ the South Carolina Uniform Principal and Income Act;

(3) shall administer a trust or estate in accordance with ~~this part~~ the South Carolina Uniform Principal and Income Act if the terms of the trust or the will do not contain a different provision or do not give the fiduciary a discretionary power of administration; and

(4) shall add a receipt or charge a disbursement to principal to the extent that the terms of the trust and ~~this part~~ the South Carolina Uniform Principal and Income Act do not provide a rule for allocating the receipt or disbursement to or between principal and income.

(B) In exercising:

(1) the power to adjust pursuant to Section 62-7-904(A);

(2) a discretionary power in connection with the conversion or administration of a unitrust under Sections 62-7-904B through Section 62-7-904P; or

(3) a discretionary power of administration regarding a matter within the scope of ~~this part~~ the South Carolina Uniform Principal and Income Act, whether granted by the terms of a trust, a will, or ~~this part~~ the South Carolina

Uniform Principal and Income Act, a fiduciary shall administer a trust or estate impartially, based on what is fair and reasonable to all of the beneficiaries, except to the extent that the terms of the trust or the will clearly manifest an intention that the fiduciary shall or may favor one or more of the beneficiaries. A determination in accordance with ~~this part~~ the South Carolina Uniform Principal and Income Act is presumed to be fair and reasonable to all of the beneficiaries.

REPORTER'S COMMENT

Prior Act. The rule in Section 62-7-404(1) of the 1963 SC Act is restated in Section 62-7-903(a), without changing its substance, to emphasize that this Act contains only default rules and that provisions in the terms of the trust are paramount. However, Section 62-7-404(a) of the 1963 SC Act applied only to the allocation of receipts and disbursements to or between principal and income. In this Act, the first sentence of Section 62-7-903(A) states that it also applies to matters within the scope of Sections 62-7-905 through 62-7-909. Section 62-7-903(A)(2) incorporates the rule in Section 62-7-404(b) of the 1963 SC Act that a discretionary allocation made by the trustee that is contrary to a rule in the Act should not give rise to an inference of imprudence or partiality by the trustee.

The Act deletes the language that appears at the end of 1963 SC Act Section 62-7-404(a)(3) - "and in view of the manner in which men of ordinary prudence, discretion and judgment would act in the management of their affairs" - because persons of ordinary prudence, discretion and judgment, acting in the management of their own affairs do not normally think in terms of the interests of successive beneficiaries. If there is an analogy to an individual's decision-making process, it is probably the individual's decision to spend or to save, but this is not a useful guideline for trust administration. No case has been found in

which a court has relied on the “prudent man” rule of the 1963 SC Act.

Fiduciary discretion. The general rule is that if a discretionary power is conferred upon a trustee, the exercise of that power is not subject to control by a court except to prevent an abuse of discretion. Restatement (Second) of Trusts Sec 187. The situations in which a court will control will control the exercise of a trustee’s discretion are discussed in the comments to Sec 187. See also id. Sec 233 Comment p.

Questions for which there is no provision. Section 62-7-903(A)(4) allocates receipts and disbursements to principal when there is no provision for a different allocation in the terms of the trust, the will, or the Act. This may occur because money is received from a financial instrument not available at the present time (inflation-indexed bonds might have fallen into this category had they been announced after the Uniform Act was approved by the Commissioners on Uniform State Laws) or because a transaction is of a type or occurs in a manner not anticipated by the Drafting Committee for the Uniform Act or the drafter of the trust instrument.

Allocating to principal a disbursement for which there is no provision in the Act or the terms of the trust preserves the income beneficiary’s level of income in the year it is allocated to principal, but thereafter will reduce the amount of income produced by the principal. Allocating to principal a receipt for which there is no provision will increase the income received by the income beneficiary in subsequent years, and will eventually, upon termination of the trust, also favor the remainder beneficiary. Allocating these items to principal implements the rule that requires a trustee to administer the trust impartially, based on what is fair and reasonable to both income and remainder beneficiaries. However, if the trustee decides that an adjustment between principal and income is needed to enable the trustee to comply with Section 62-7-903(B) after considering the return from the portfolio as a

whole, the trustee may make an appropriate adjustment under Section 62-7-904(A).

Duty of impartiality. Whenever there are two or more beneficiaries, a trustee is under a duty to deal impartially with them. Restatement of Trusts 3d: Prudent Investor Rule Sec 183 (1992). This rule applies whether the beneficiaries' interests in the trust are concurrent or successive. If the terms of the trust give the trustee discretion to favor one beneficiary over another, a court will not control the exercise of such discretion except to prevent the trustee from abusing it. *Id.* Sec 183, Comment *a.* "The precise meaning of the trustee's duty of impartiality and the balancing of competing interests and objectives inevitably are matters of judgment and interpretation. Thus, the duty and balancing are affected by the purposes, terms, distribution requirements, and other circumstances of the trust, not only at the outset but as they may change from time to time." *Id.* Sec 232, Comment *c.*

The terms of a trust may provide that the trustee, or an accountant engaged by the trustee, or a committee of persons who may be family members or business associates, shall have the power to determine what is income and what is principal. If the terms of a trust provide that this Act specifically or principal and income legislation in general does not apply to the trust but fail to provide a rule to deal with a matter provided for in this Act, the trustee has an implied grant of discretion to decide the question. Section 62-7-903(B) provides that the rule of impartiality applies in the exercise of such a discretionary power to the extent that the terms of the trust do not provide that one or more of the beneficiaries are to be favored. The fact that a person is named an income beneficiary or a remainder beneficiary is not by itself an indication of partiality for that beneficiary.

SECTION 62-7-904. Adjustments between principal and income.

(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 provisions in Section 62-7-903(A), that the trustee is unable to comply with Section 62-7-903(B).

(B) In deciding whether and to what extent to exercise the power of adjustment in subsection (A), a trustee shall consider all factors relevant to the trust and its beneficiaries, including:

- (1) nature, purpose, and expected duration of the trust;
- (2) intent of the settlor;
- (3) identity and circumstances of the beneficiaries;
- (4) needs for liquidity, regularity of income, and preservation and appreciation of capital;
- (5) assets held in the trust and the extent to which they consist of financial assets, interests in closely held enterprises, tangible and intangible personal property, or real property and the extent to which an asset is used by a beneficiary, and whether an asset was purchased by the trustee or received from the settlor;
- (6) net amount otherwise allocated to income and the increase or decrease in the value of the principal assets, which the trustee may estimate as to assets for which market values are not readily available;
- (7) terms of the trust and whether and to what extent they give the trustee the power to invade principal or accumulate income or prohibit the trustee from invading principal or accumulating income, and the extent to which the trustee has exercised a power from time to time to invade principal or accumulate

SECTION 62-7-904.

(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 provisions in Section 62-7-903(A), that the trustee is unable to comply with Section 62-7-903(B). In lieu of exercising the power to adjust, the trustee may convert the trust to a unitrust as permitted under Sections 62-7-904A through 62-7-904P, in which case the unitrust amount becomes the net income of the trust.

(B) In deciding whether and to what extent to exercise the power ~~of adjustment to adjust~~ in subsection (A), a trustee shall consider all factors relevant to the trust and its beneficiaries, including, but not limited to:

- (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 assets held in the trust and the extent to which they consist of financial assets, interests in closely held enterprises, tangible and intangible personal property, or real property and the extent to which an asset is used by a beneficiary, and whether an asset was purchased by the trustee or received from the settlor;
- (6) the net amount otherwise allocated to income under other sections of the South Carolina Uniform Principal and Income Act and the increase or decrease in the value of the principal assets, which the trustee may estimate as to assets for which market values are not readily available;
- (7) ~~terms of the trust and~~ whether and to what extent they the terms of the trust give the

<p>income;</p> <p>(8) actual and anticipated effect of economic conditions on principal and income and effects of inflation and deflation; and</p> <p>(9) anticipated tax consequences of an adjustment.</p> <p>(C) A trustee may not make an adjustment:</p> <p>(1) that diminishes the income interest in a trust that requires all of the income to be paid at least annually to a surviving spouse and for which an estate tax or gift tax marital deduction is allowed, in whole or in part, if the trustee did not have the power to make the adjustment;</p> <p>(2) 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;</p> <p>(3) that changes the amount payable to a beneficiary as a fixed annuity or a fixed fraction of the value of the trust assets;</p> <p>(4) 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;</p> <p>(5) if possessing or exercising the power to make an adjustment is determinative in causing an individual to be treated as the owner of all or part of the trust for income tax purposes;</p> <p>(6) if possessing or exercising the power to make an adjustment is determinative in causing all or 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;</p> <p>(7) if the trustee is a beneficiary of the trust; or</p> <p>(8) if the trustee is not a beneficiary, but the adjustment benefits the trustee directly or indirectly.</p> <p>(D) If subsection (C)(5), (6), (7), or (8) applies to a trustee and there is more than one trustee, a cotrustee to whom the provision does not apply may make the adjustment unless the exercise of the power by the</p>	<p>trustee the power to invade principal or accumulate income or prohibit the trustee from invading principal or accumulating income, and the extent to which the trustee has exercised a power from time to time to invade principal or accumulate income;</p> <p>(8) <u>the</u> actual and anticipated effect of economic conditions on principal and income and effects of inflation and deflation; and</p> <p>(9) <u>the</u> anticipated tax consequences of an adjustment.</p> <p>(C) A trustee may not make an adjustment:</p> <p>(1) that diminishes the income interest in a trust that requires all of the income to be paid at least annually to a surviving spouse and for which an estate tax or gift tax marital deduction is allowed, in whole or in part, if the trustee did not have the power to make the adjustment, <u>but only to the extent that making such an adjustment would cause adverse tax consequences under applicable tax laws and regulations;</u></p> <p>(2) 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;</p> <p>(3) that changes the amount payable to a beneficiary as a fixed annuity or a fixed fraction of the value of the trust assets;</p> <p>(4) 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, <u>but only to the extent that making such an adjustment would cause adverse tax consequences under applicable tax laws and regulations;</u></p> <p>(5) if possessing or exercising the power to make an adjustment is determinative in causing an individual to be treated as the owner of all or part of the trust for income tax purposes <u>and the individual would not be treated as the owner if the trustee did not possess the power to make an adjustment;</u></p> <p>(6) if possessing or exercising the power to make an adjustment is determinative in causing all or part of the trust assets to be included for</p>
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<p>remaining trustee or trustees is not permitted by the terms of the trust.</p> <p>(E) A trustee may release the entire power of adjustment in subsection (A) or may release only the power to adjust from income to principal or the power to adjust from principal to income if the trustee is uncertain about whether possessing or exercising the power causes a result described in subsection (C)(1) through (6) or (C)(8) or if the trustee determines that possessing or exercising the power may deprive the trust of a tax benefit or impose a tax burden not contemplated in subsection (C). The release may be permanent or for a specified period, including a period measured by the life of an individual.</p> <p>(F) Terms of a trust that limit the power of a trustee to make an adjustment between principal and income do not affect the application of this section unless it is clear from the terms of the trust that the terms are intended to deny the trustee the power of adjustment in subsection (A).</p>	<p>estate tax purposes in the estate of an individual who has the power to remove a trustee or appoint a trustee, or both, <u>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;</u></p> <p>(7) if the trustee is a beneficiary of the trust; or</p> <p>(8) if the trustee is not a beneficiary, but the adjustment benefits <u>would benefit</u> the trustee directly or indirectly, <u>except that a trustee may make an adjustment that also benefits a beneficiary even if the terms of the trust provide for trustee compensation as a percentage of the trust's income; or</u></p> <p>(9) <u>if the trust has been converted to, and is then operating as a unitrust under Sections 62-7-904B through 62-7-904P.</u></p> <p>(D) If subsection (C)(5), (6), (7), or (8) applies to a trustee and there is more than one trustee, a cotrustee 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.</p> <p>(E) A trustee may release the entire power of adjustment in subsection (A) or may release only the power to adjust from income to principal or the power to adjust from principal to income if the trustee is uncertain about whether possessing or exercising the power causes a result described in subsection <u>subsections</u> (C)(1) through (6) or <u>subsection</u> (C)(8) or if the trustee determines that possessing or exercising the power <u>will or</u> may deprive the trust of a tax benefit or impose a tax burden not contemplated in subsection (C). The release may be permanent or for a specified period, including a period measured by the life of an individual.</p> <p>(F) Terms of a trust that limit the power of a trustee to make an adjustment between principal and income do not affect the application of this section unless it is clear from the terms of the trust that the terms are intended to deny the trustee the power of adjustment to adjust in</p>
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subsection (A).

REPORTER'S COMMENTS

Purpose and Scope of Provision. The purpose of Section 62-7-904 is to enable a trustee to select investments using the standards of a prudent investor without having to realize a particular portion of the portfolio's total return in the form of traditional trust accounting income such as interest, dividends, and rents. Section 62-7-904(A) authorizes a trustee to make adjustments between principal and income if three conditions are met: (1) the trustee must be managing the trust assets under the prudent investor rule; (2) the terms of the trust must express the income beneficiary's distribution rights in terms of the right to receive "income" in the sense of traditional trust accounting income; and (3) the trustee must determine, after applying the rules in Section 62-7-903(A) that he is unable to comply with Section 62-7-903(B). In deciding whether and to what extent to exercise the power to adjust, the trustee is required to consider the factors described in Section 62-7-904(B) but the trustee may not make an adjustment in circumstances described in Section 62-7-904(C).

Section 62-7-904 does not empower a trustee to increase or decrease the degree of beneficial enjoyment to which a beneficiary is entitled under the terms of the trust; rather, it authorizes the trustee to make adjustments between principal and income that may be necessary if the income component of a portfolio's total return is too small or too large because of investment decisions made by the trustee under the prudent investor rule. The paramount consideration in applying Section 62-7-904(A) is the requirement in Section 62-7-903(B) that "a fiduciary must administer a trust or estate impartially, based on what is fair and reasonable to all of the beneficiaries, except to the extent that the terms of the trust or the will clearly manifest an intention that the fiduciary shall or may favor one or more of the beneficiaries."

The power to adjust is subject to control by the court to prevent an abuse of discretion. Restatement (Second) of Trusts Sec.187 (1959). See also id. Sections 183, 232, 233, Comment *p* (1959).

Section 62-7-904 will be important for trusts that are irrevocable when a State adopts the prudent investor rule by statute or judicial approval of the rule in Restatement of Trusts 3d: Prudent Investor Rule. Wills and trust instruments executed after the rule is adopted can be drafted to describe a beneficiary's distribution rights in terms that do not depend upon the amount of trust accounting income, but to the extent that drafters of trust documents continue to describe an income beneficiary's distribution rights by referring to trust accounting income, Section 62-7-904 will be an important tool in trust administration.

Three conditions to the exercise of the power to adjust. The first of the three conditions that must be met before a trustee can exercise the power to adjust - that the trustee invest and manage trust assets as a prudent investor - is expressed in this Act by language derived from the Uniform Prudent Investor Act (UPIA), but the condition will be met whether the prudent investor rule applies because the UPIA or other prudent investor legislation has been enacted, the prudent investor rule has been approved by the courts, or the terms of the trust require it. Even if a State's legislature or courts have not formally adopted the prudent investor rule, the Restatement establishes the prudent investor rule as an authoritative interpretation of the common law prudent man rule, referring to the prudent investor rule as a "modest reformulation of the Harvard College dictum and the basic rule of prior Restatements." Restatement of Trusts 3d: Prudent Investor Rule, Introduction, at 5. As a result, there is a basis for concluding that the first condition is satisfied in virtually all States except those in which a trustee is permitted to invest only in assets set forth in a statutory "legal list."

The second condition will be 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 require a trustee to distribute all of the income, but permit the trustee to decide how much to distribute to each member of a class of beneficiaries; or when the terms of a trust provide that the beneficiary shall receive the greater of the trust accounting income and a fixed dollar amount (an annuity), or of trust accounting income and a fractional share of the value of the trust assets (a unitrust amount). If the trust authorizes the trustee in its discretion to distribute the trust’s income to the beneficiary or to accumulate some or all of the income, the condition will be met because the terms of the trust do not permit the trustee to distribute more than the trust accounting income.

To meet the third condition, the trustee must first meet the requirements of Section 62-7-903(A), i.e., he must apply the terms of the trust, decide whether to exercise the discretionary powers given to the trustee under the terms of the trust, and must apply the provisions of the Act if the terms of the trust do not contain a different provision or give the trustee discretion. Second, the trustee must determine the extent to which the terms of the trust clearly manifest an intention by the settlor that the trustee may or must favor one or more of the beneficiaries. To the extent that the terms of the trust do not require partiality, the trustee must conclude that he is unable to comply with the duty to administer the trust impartially. To the extent that the terms of the trust do require or permit the trustee to favor the income beneficiary or the remainder beneficiary, the trustee must conclude that he is unable to achieve the degree of partiality required or permitted. If the trustee comes to either conclusion - that he is unable to administer the trust impartially or that he is unable to achieve the degree of partiality required or permitted - he may exercise the power to adjust under Section 62-7-904(A).

Impartiality and productivity of income. The duty of impartiality between income and

remainder beneficiaries is linked to the trustee's duty to make the portfolio productive of trust accounting income whenever the distribution requirements are expressed in terms of distributing the trust's "income." The 1962 Act and the 1963 SC Act imply that the duty to produce income applies on an asset by asset basis because the right of an income beneficiary to receive "delayed income" from the sale proceeds of underproductive property under Section 62-7-415 of that Act arises if "any part of principal ... has not produced an average net income of a least one percent per year of its inventory value for more than a year" Under the prudent investor rule, "[t]o whatever extent a requirement of income productivity exists, ... the requirement applies not investment by investment but to the portfolio as a whole." Restatement of Trusts 3d: Prudent Investor Rule Sec 227, Comment *i*, at 34. The power to adjust under Section 62-7-904(A) is also to be exercised by considering net income from the portfolio as a whole and not investment by investment. Section 62-7-922(B) of this Act eliminates the underproductive property rule in all cases other than trusts for which a marital deduction is allowed; the rule applies to a marital deduction trust if the trust's assets "consist substantially of property that does not provide the spouse with sufficient income from or use of the trust assets ..." - in other words, the section applies by reference to the portfolio as a whole.

While the purpose of the power to adjust in Section 62-7-904(A) is to eliminate the need for a trustee who operates under the prudent investor rule to be concerned about the income component of the portfolio's total return, the trustee must still determine the extent to which a distribution must be made to an income beneficiary and the adequacy of the portfolio's liquidity as a whole to make that distribution.

For a discussion of investment considerations involving specific investments and techniques under the prudent investor rule, see Restatement of Trusts 3d: Prudent Investor Rule Sec 227,

Comments *k-p*.

Factors to consider in exercising the power to adjust. Section 62-7-904(B) requires a trustee to consider factors relevant to the trust and its beneficiaries in deciding whether and to what extent the power to adjust should be exercised. Section 62-7-933(C)(3) of the South Carolina Uniform Prudent Investor Act (SCUPIA) sets forth circumstances that a trustee is to consider in investing and managing trust assets. The circumstances in Section 62-7-933(C)(3) of the SCUPIA are the source of the factors in paragraphs (3) through (6) and (8) of Section 62-7-904(B) (modified where necessary to adapt them to the purposes of this Act) so that, to the extent possible, comparable factors will apply to investment decisions and decisions involving the power to adjust. If a trustee who is operating under the prudent investor rule decides that the portfolio should be composed of financial assets whose total return will result primarily from capital appreciation rather than dividends, interest, and rents, the trustee can decide at the same time the extent to which an adjustment from principal to income may be necessary under Section 62-7-904. On the other hand, if a trustee decides that the risk and return objectives for the trust are best achieved by a portfolio whose total return includes interest and dividend income that is sufficient to provide the income beneficiary with the beneficial interest to which the beneficiary is entitled under the terms of the trust, the trustee can decide that it is unnecessary to exercise the power to adjust.

Assets received from the settlor. Section 62-7-933(D) of SCUPIA provides that “[a] trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying.” The special circumstances may include the wish to retain a family business, the benefit derived from deferring liquidation of the asset in order to defer payment of income taxes, or the anticipated capital appreciation from retaining an asset such as undeveloped real

estate for a long period. To the extent the trustee retains assets received from the settlor because of special circumstances that overcome the duty to diversify, the trustee may take these circumstances into account in determining whether and to what extent the power to adjust should be exercised to change the results produced by other provisions of this Act that apply to the retained assets. See Section 62-7-904(B)(5); Uniform Prudent Investor Act Sec 3, Comment, 7B U.L.A. 18, at 25-26 (Supp. 1997); Restatement of Trusts 3d: Prudent Investor Rule Sec 229 and Comments *a-e*.

Limitations on Section 62-7-904 power to adjust. The purpose of subsections (C)(1) through (4) is to preserve tax benefits that may have been an important purpose for creating the trust. Subsections (C)(5), (6), and (8) deny the power to adjust in the circumstances described in those subsections in order to prevent adverse tax consequences, and subsection (C)(7) denies the power to adjust to any beneficiary, whether or not possession of the power may have adverse tax consequences.

Under subsection (C)(1), a trustee cannot make an adjustment that diminishes the income interest in a trust that requires all of the income to be paid at least annually to a spouse and for which an estate tax or gift tax marital deduction is allowed; but this subsection does not prevent the trustee from making an adjustment that increases the amount of income paid from a marital deduction trust to the spouse. Subsection (C)(1) applies to a trust that qualifies for the marital deduction because the spouse has a general power of appointment over the trust, but it applies to a qualified terminable interest property (QTIP) trust only if and to the extent that the fiduciary makes the election required to obtain the tax deduction. Subsection (C)(1) does not apply to a so-called "estate" trust. This type of trust qualifies for the marital deduction because the terms of the trust require the principal and undistributed income to be paid to the surviving spouse's estate when the spouse dies; it is not necessary for the terms of an estate

trust to require the income to be distributed annually. Reg. Sec 20.2056(c)-2(b)(1)(iii).

Subsection (C)(3) applies to annuity trusts and unitrusts with no charitable beneficiaries as well as to trusts with charitable income or remainder beneficiaries; its purpose is to make it clear that a beneficiary's right to receive a fixed annuity or a fixed fraction of the value of a trust's assets is not subject to adjustment under Section 62-7-904(A). Subsection (C)(3) does not apply to any additional amount to which the beneficiary may be entitled that is expressed in terms of a right to receive income from the trust. For example, if a beneficiary is to receive a fixed annuity or the trust's income, whichever is greater, subsection (C)(3) does not prevent a trustee from making an adjustment under Section 62-7-904(A) in determining the amount of the trust's income.

If subsection (C)(5), (6), (7), or (8), prevents a trustee from exercising the power to adjust, subsection (D) permits a cotrustee who is not subject to the provision to exercise the power unless the terms of the trust do not permit the cotrustee to do so.

Release of the power to adjust. Section 62-7-904(E) permits a trustee to release all or part of the power to adjust in circumstances in which the possession or exercise of the power might deprive the trust of a tax benefit or impose a tax burden. For example, if possessing the power would diminish the actuarial value of the income interest in a trust for which the income beneficiary's estate may be eligible to claim a credit for property previously taxed if the beneficiary dies within ten years after the death of the person creating the trust, the trustee is permitted under subsection to release (E) to release just the power to adjust from income to principal.

Trust terms that limit a power to adjust. Section 62-7-904(F) applies to trust provisions that limit a trustee's power to adjust. Since the power is intended to enable trustees to employ the prudent investor rule without being constrained by traditional principal and income

rules, an instrument executed before the adoption of this Act whose terms describe the amount that may or must be distributed to a beneficiary by referring to the trust's income or that prohibit the invasion of principal or that prohibit equitable adjustments in general should not be construed as forbidding the use of the power to adjust under Section 62-7-904(A) if the need for adjustment arises because the trustee is operating under the prudent investor rule. Instruments containing such provisions that are executed after the adoption of this Act should specifically refer to the power to adjust if the settlor intends to forbid its use. See generally, Joel C. Dobris, *Limits on the Doctrine of Equitable Adjustment in Sophisticated Postmortem Tax Planning*, 66 Iowa L. Rev. 273 (1981).

Examples. The following examples illustrate the application of Section 62-7-904:

Example (1) T is the successor trustee of a trust that provides income to A for life, remainder to B. T has received from the prior trustee a portfolio of financial assets invested 20% in stocks and 80% in bonds. Following the prudent investor rule, T determines that a strategy of investing the portfolio 50% in stocks and 50% in bonds has risk and return objectives that are reasonably suited to the trust, but T also determines that adopting this approach will cause the trust to receive a smaller amount of dividend and interest income. After considering the factors in Section 62-7-904(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 62-7-915 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 income from her social security, pension, and savings exceeds the amount required to provide for her accustomed standard of living. The terms of the trust permit T to invade principal to provide 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 dividend 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, and T may transfer cash from principal to income to provide her with that degree of enjoyment.

Example (4) T is the trustee of a trust that is governed by the law of State X. The trust became irrevocable before State X adopted the prudent investor rule. The terms of the trust require all of the income to be paid to G for life, remainder to H, and also give T the power to invade principal for the benefit of G for "dire emergencies only." The terms of the trust limit the aggregate amount that T can distribute to G from principal during G's life to 6% of the trust's value at its inception. The trust's portfolio is invested initially 50% in stocks and 50% in bonds, but after State X adopts the prudent investor rule T determines that, to achieve suitable risk and return objectives for the trust, the assets should be invested 90% in stocks and 10% in bonds. This change increases the total return from the portfolio and decreases the dividend and interest income. Thereafter, even though G does not experience a dire emergency, T may exercise the power to adjust under Section 62-7-904(A) to the extent that T determines that the adjustment is from only the

capital appreciation resulting from the change in the portfolio's asset allocation. If T is unable to determine the extent to which capital appreciation resulted from the change in asset allocation or is unable to maintain adequate records to determine the extent to which principal distributions to G for dire emergencies do not exceed the 6% limitation, T may not exercise the power to adjust. See Joel C. Dobris, *Limits on the Doctrine of Equitable Adjustment in Sophisticated Postmortem Tax Planning*, 66 Iowa L. Rev. 273 (1981).

Example (5) T is the trustee of a trust for the settlor's child. The trust owns a diversified portfolio of marketable financial assets with a value of \$600,000, and is also the sole beneficiary of the settlor's IRA, which holds a diversified portfolio of marketable financial assets with a value of \$900,000. The trust receives a distribution from the IRA that is the minimum amount required to be distributed under the Internal Revenue Code, and T allocates 10% of the distribution to income under Section 62-7-918(C) of this Act. The total return on the IRA's assets exceeds the amount distributed to the trust, and the value of the IRA at the end of the year is more than its value at the beginning of the year. Relevant 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 62-7-903(B) include the total return from all of the trust's assets, those owned directly as well as its interest in the IRA, the extent to which the trust will be subject to income tax on the portion of the IRA distribution that is allocated to principal, and the extent to which the income beneficiary will be subject to income tax on the amount that T distributes 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 real property taxes on the undeveloped parcel from income each year pursuant to Section 62-7-925(3). After considering the return from the trust's portfolio

as a whole and other relevant factors described in Section 62-7-904(B), T may exercise the power to adjust under Section 62-7-904(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 62-7-903(B).

Example (7) T is the trustee of a trust whose portfolio includes an interest in a mutual fund that is 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 62-7-925(1) and the other one-half would have been paid from principal under Section 62-7-926(A)(1). After considering the total return from the portfolio as a whole and other relevant factors described in Section 62-7-904(B), T may exercise its power to adjust under Section 62-7-904(A) by transferring \$1,000, or half of the trust's proportionate share of the fee, from principal to income.

Section 62-7-904A. (A) A court may not change a fiduciary's decision, or order a fiduciary to change its decision, to exercise or not to exercise a discretionary power conferred by the South Carolina Uniform Principal and Income Act unless it determines that the decision was an abuse of the fiduciary's discretion. A fiduciary's decision is not an abuse of discretion merely because the court would have exercised the power in a different manner or would not have exercised the power.

(B) The decisions subject to subsection (A) include, but are not limited to, a determination:

(1) pursuant to Section 62-7-904(A) of whether and to what extent an amount should be transferred from principal to income or from income to principal; and

(2) of the factors that are relevant to the trust and its beneficiaries, the extent to which they are relevant, and the weight, if any, to be given to the relevant factors, in deciding

whether and to what extent to exercise the power in Section 62-7-904(A).

(C) If a court determines that a fiduciary has abused its discretion, the court may place the income and remainder beneficiaries in the positions they would have occupied if the fiduciary had not abused its discretion, according to the following rules:

(1) to the extent that the abuse of discretion has resulted in no distribution to a beneficiary or in a distribution that is too small, the court must order the fiduciary to distribute from the trust to the beneficiary an amount that the court determines will restore the beneficiary, in whole or in part, to the beneficiary's appropriate position;

(2) to the extent that the abuse of discretion has resulted in a distribution to a beneficiary that is too large, the court must place the beneficiaries, the trust, or both, in whole or in part, in their appropriate positions by ordering the fiduciary to withhold an amount from one or more future distributions to the beneficiary who received the distribution that was too large or ordering that beneficiary to return some or all of the distribution to the trust;

(3) to the extent that the court is unable, after applying items (1) and (2), to place the beneficiaries, the trust, or both, in the positions they would have occupied if the fiduciary had not abused its discretion, the court may order the fiduciary to pay an appropriate amount from its own funds to one or more of the beneficiaries or the trust, or both.

(D) Upon a petition by the fiduciary, the court having jurisdiction over the trust or estate must determine whether a proposed exercise or nonexercise by the fiduciary of a discretionary power in the South Carolina Uniform Principal and Income Act would result in an abuse of the fiduciary's discretion. If the petition describes the proposed exercise or nonexercise of the power and contains sufficient information to inform the beneficiaries of the reasons for the proposal, the facts upon which the fiduciary relies, and an explanation of how the income

and remainder beneficiaries would be affected by the proposed exercise or nonexercise of the power, a beneficiary who challenges the proposed exercise or nonexercise has the burden of establishing that it will result in an abuse of discretion.

REPORTER'S COMMENTS

General. All of the discretionary powers in this 1997 Act are subject to the normal rules that govern a fiduciary's exercise of discretion. Section 62-7-932 codifies those rules for purposes of the Act so that they will be readily apparent and accessible to fiduciaries, beneficiaries, their counsel and the courts if and when questions concerning such powers arise.

Section 62-7-932 also makes clear that the normal rules governing the exercise of a fiduciary's powers apply to the discretionary power to adjust conferred upon a trustee by Section 62-7-904(A). Discretionary provisions authorizing trustees to determine what is income and what is principal have been used in governing instruments for years; Section 2 of the 1931 Uniform Principal and Income Act recognized that practice by providing that "the person establishing the principal may himself direct the manner of ascertainment of income and principal...or grant discretion to the trustee or other person to do so...." Section 62-7-903(A)(2) also recognizes the power of a settlor to grant such discretion to the trustee. Section 62-7-932 applies to a discretionary power granted by the terms of a trust or a will as well as the power to adjust in Section 62-7-904(A).

Power to Adjust. The exercise of the power to adjust is governed by a trustee's duty of impartiality, which requires the trustee to strike an appropriate balance between the interests of the income and remainder beneficiaries. Section 62-7-903(B) expresses this duty by requiring the trustee to "administer a trust or estate impartially, based on what is fair and reasonable to all of the beneficiaries, except to the extent

that the terms of the trust or the will clearly manifest an intention that the fiduciary shall or may favor one or more of the beneficiaries.” Because this involves the exercise of judgment in circumstances rarely capable of perfect resolution, trustees are not expected to achieve perfection; they are, however, required to make conscious decisions in good faith and with proper motives.

In seeking the proper balance between the interests of the beneficiaries in matters involving principal and income, a trustee’s traditional approach has been to determine the settlor’s objectives from the terms of the trust, gather the information needed to ascertain the financial circumstances of the beneficiaries, determine the extent to which the settlor’s objectives can be achieved with the resources available in the trust, and then allocate the trust’s assets between stocks and fixed-income securities in a way that will produce a particular level or range of income for the income beneficiary. The key element in this process has been to determine the appropriate level or range of income for the income beneficiary, and that will continue to be the key element in deciding whether and to what extent to exercise the discretionary power conferred by Section 62-7-904(A). If it becomes necessary for a court to determine whether an abuse of the discretionary power to adjust between principal and income has occurred, the criteria should be the same as those that courts have used in the past to determine whether a trustee has abused its discretion in allocating the trust’s assets between stocks and fixed-income securities.

A fiduciary has broad latitude in choosing the methods and criteria to use in deciding whether and to what extent to exercise the power to adjust in order to achieve impartiality between income beneficiaries and remainder beneficiaries or the degree of partiality for one or the other that is provided for by the terms of the trust or the will. For example, in deciding what the appropriate level or range of income should be for the income beneficiary and

whether to exercise the power, a trustee may use the methods employed prior to the enactment of SCUP&IA in 2001 in deciding how to allocate trust assets between stocks and fixed-income securities; or may consider the amount that would be distributed each year based on a percentage of the portfolio's value at the beginning or end of an accounting period, or the average portfolio value for several accounting periods, in a manner similar to a unitrust, and may select a percentage that the trustee believes is appropriate for this purpose and use the same percentage or different percentages in subsequent years. The trustee may also use hypothetical portfolios of marketable securities to determine an appropriate level or range of income within which a distribution might fall.

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

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

Under the prudent investor rule, a trustee is to incur costs that are appropriate and reasonable in relation to the assets and the purposes of the trust, and the same consideration applies in determining whether and to what extent to exercise the power to adjust. In making

investment decisions under the prudent investor rule, the trustee will have considered the purposes, terms, distribution requirements, and other circumstances of the trust for the purpose of adopting an overall investment strategy having risk and return objectives reasonably suited to the trust. A trustee is not required to duplicate that work for principal and income purposes, and in many cases the decision about whether and to what extent to exercise the power to adjust may be made at the same time as the investment decisions. To help achieve the objective of reasonable investment costs, a trustee may also adopt policies that apply to all trusts or to individual trusts or classes of trusts, based on their size or other criteria, stating whether and under what circumstances the power to adjust will be exercised and the method of making adjustments; no inference of abuse is to be drawn if a trustee adopts such policies.

General rule. The first sentence of Section 62-7-932(A) is from Restatement (Second) of Trusts Sec 187 and Restatement (Third) of Trusts (Tentative Draft No. 2, 1999) Sec 50(1). The second sentence of Section 62-7-932(A) derives from Comment e to Sec 187 of the Second Restatement and Comment b to Sec 50 of the Third Restatement.

The reference in Section 62-7-932(A) to a fiduciary's decision to exercise or not to exercise a discretionary power underscores a fundamental precept, which is that a fiduciary has a duty to make a conscious decision about exercising or not exercising a discretionary power. Comment b to Sec 50 of the Third Restatement states:

A court will intervene where the exercise of a power is left to the judgment of a trustee who improperly fails to exercise that judgment. Thus, even where a trustee has discretion whether or not to make any payments to a particular beneficiary, the court will interpose if the trustee, arbitrarily or without knowledge of or inquiry into relevant circumstances, fails to exercise the discretion.

Section 62-7-932(B) makes clear that the rule of subsection (A) applies not only to the power conferred by Section 62-7-904(A) but also to the evaluation process required by Section 62-7-904(B) in deciding whether and to what extent to exercise the power to adjust. Under Section 62-7-904(B) a trustee is to consider all of the factors that are relevant to the trust and its beneficiaries, including, to the extent the trustee determines they are relevant, the nine factors enumerated in Section 62-7-904(B). Section 62-7-904(B) derives from Section 62-7-933(C)(3) of SCUPIA which lists eight circumstances that a trustee shall consider, to the extent they are relevant, in investing and managing assets. The trustee's decisions about what factors are relevant for purposes of Section 62-7-904(B) and the weight to be accorded each of the relevant factors are part of the discretionary decision-making process. As such, these decisions are not subject to change for the purpose of changing the trustee's ultimate decision unless the court determines that there has been an abuse of discretion in determining the relevancy and weight of these factors.

Remedy. The exercise or nonexercise of a discretionary power under the Act normally affects the amount or timing of a distribution to the income or remainder beneficiaries. The primary remedy under Section 62-7-932(C) for abuse of discretion is the restoration of the beneficiaries and the trust to the positions they would have occupied if the abuse had not occurred. It draws on a basic principle of restitution that if a person pays money to someone who is not intended to receive it (and in a case to which this Act applies, not intended by the settlor to receive it in the absence of an abuse of discretion by the trustee), that person is entitled to restitution on the ground that the payee would be unjustly enriched if he were permitted to retain the payment. See Restatement of Restitution Sec 22 (1937). The objective is to accomplish the restoration initially by making adjustments between the

beneficiaries and the trust to the extent possible; to the extent that restoration is not possible by such adjustments, a court may order the trustee to pay an amount to one or more of the beneficiaries, the trust, or both the beneficiaries and the trust. If the court determines that it is not possible in the circumstances to restore them to their appropriate positions, the court may provide other remedies appropriate to the circumstances. The approach of Section 105(c) is supported by Comment b to Sec 50 of the Third Restatement of Trusts:

When judicial intervention is required, a court may direct the trustee to make or refrain from making certain payments; issue instructions to clarify the standards or guidelines applicable to the exercise of the power; or rescind the trustee's payment decisions, usually directing the trustee to recover amounts improperly distributed and holding the trustee liable for failure or inability to do so.

Advance determinations. Section 62-7-932(D) employs the familiar remedy of the trustee's petition to the court for instructions. It requires the court to determine, upon a petition by the fiduciary, whether a proposed exercise or nonexercise of a discretionary power by the fiduciary of a power conferred by the Act would be an abuse of discretion under the general rule of Section 62-7-932(A). If the petition contains the information prescribed in the second sentence of subsection (D) the proposed action or inaction is presumed not to result in an abuse, and a beneficiary who challenges the proposal must establish that it will.

Subsection (D) is intended to provide a fiduciary the opportunity to obtain an assurance of finality in a judicial proceeding before proceeding with a proposed exercise or nonexercise of a discretionary power. Its purpose is not, however, to have the court instruct the fiduciary how to exercise the discretion.

A fiduciary may also obtain the consent of the beneficiaries to a proposed act or an omission to act, and a beneficiary cannot hold the fiduciary

liable for that act or omission unless:

(a) the beneficiary was under an incapacity at the time of such consent or of such act or omission; or

(b) the beneficiary, when he gave his consent, did not know of his rights and of the material facts which the trustee knew or should have known and which the trustee did not reasonably believe that the beneficiary knew; or

(c) the consent of the beneficiary was induced by improper conduct of the trustee.

Restatement (Second) of Trusts Sec 216.

If there are many beneficiaries, including some who are incapacitated or unascertained, the fiduciary may prefer the greater assurance of finality provided by a judicial proceeding that will bind all persons who have an interest in the trust.

Section 62-7-904B. The definitions in this section apply to Sections 62-7-904C through 62-7-904P.

(1) 'Code' means the Internal Revenue Code of 1986, as amended from time to time, and any statutory enactment successor to the Code; reference to a specific section of the code in Sections 62-7-904B through 62-7-904P are considered a reference also to any successor provision dealing with the subject matter of that section of the Code.

(2) 'Disinterested person' means a person who is not a related or subordinate party with respect to the person then acting as trustee of the trust and excludes the settlor of the trust and any interested trustee.

(3) 'Express total return unitrust' means a trust created by the terms of a governing instrument requiring the distribution at least annually of a unitrust amount equal to a fixed percentage of not less than three percent nor more than five percent a year of the net fair market value of the amounts of the trust, valued at least annually.

(4) 'Income trust' means a trust, created by either an inter vivos or a testamentary instrument, which directs or permits the trustee

to distribute the net income of the trust to one or more persons, either in fixed proportions or in amounts or proportions determined by the trustee, and regardless of whether the trust directs or permits the trustee to distribute principal of the trust to one or more of those persons.

(5) 'Interested distributee' means a living beneficiary who is a distributee or permissible distributee of trust income or principal who has the power to remove the existing trustee and designate as successor a person who may be a related or subordinate party with respect to that distributee.

(6) 'Interested trustee' means any of the following:

(a) an individual trustee who is a qualified beneficiary;

(b) a trustee who may be removed and replaced by an interested distributee;

(c) an individual trustee whose legal obligation to support a beneficiary may be satisfied by distributions of income and principal of the trust.

(7) 'Legal disability' means a person under a legal disability who is a minor, an incompetent or incapacitated person, or an unborn individual, or whose identity or location is unknown.

(8) 'Qualified beneficiary' means a qualified beneficiary as defined in Section 62-7-103(12).

(9) 'Related or subordinate party' means a related or subordinate party as defined in Section 672(c) of the Code.

(10) 'Representative' means a person who may represent and bind another as provided in Part 3 of this article, the provisions of which apply for purposes of this section and Sections 62-7-904C through 62-7-904P.

(11) 'Settlor' means an individual, including a testator, who creates a trust.

(12) 'Total return unitrust' means an income trust that has been converted under and meets the provisions of this section and Section 62-7-904C through 62-7-904P.

(13) 'Treasury regulations' means the regulations, rulings, procedures, notices, or

other administrative pronouncements issued by the Internal Revenue Service, as amended from time to time.

(14) 'Trustee' means a person acting as trustee of the trust, except as otherwise expressly provided in this section and Sections 62-7-904C through 62-7-904P whether acting in that person's discretion or on the direction of one or more persons acting in a fiduciary capacity.

(15) 'Unitrust amount' means an amount computed as a percentage of the fair market value of the assets of the trust.

Section 62-7-904C. (A) A trustee, other than an interested trustee, or, where two or more persons are acting as trustees, a majority of the trustees who are not interested trustees (in either case hereafter 'trustee') in the trustee's sole discretion and without court approval, may:

(1) convert an income trust to a total return unitrust;

(2) reconvert a total return unitrust to an income trust; or

(3) change the percentage used to calculate the unitrust amount or the method used to determine the fair market value of the trust if all of the following apply:

(a) The trustee adopts a written policy for the trust providing:

(i) in the case of a trust being administered as an income trust, that future distributions from the trust will be unitrust amounts rather than net income as determined pursuant to the South Carolina Uniform Principal and Income Act;

(ii) in the case of a trust being administered as a total return unitrust, that future distributions from the trust will be net income rather than unitrust amounts; or

(iii) that the percentage used to calculate the unitrust amount or the method used to determine the fair market value of the trust will be changed as stated in the policy.

(b) The trustee gives written notice of its intention to take the action, including copies of the written policy and Sections 62-7-904B

through 62-7-904P, to:

(i) the settlor of the trust, if living;
and

(ii) all persons who are the qualified beneficiaries of the trust at the time the notice is given. If a qualified beneficiary is under a legal disability, notice shall be given to the representative of the qualified beneficiary if a representative is available without court order.

(c) There is at least:

(i) one qualified beneficiary described in Section 62-7-103(12)(A) or (B) who is not under a legal disability or a representative of a qualified beneficiary so described; and

(ii) one qualified beneficiary described in Section 62-7-103(12)(C) who is not under a legal disability or a representative of a qualified beneficiary so described.

(d) No person receiving notice of the trustee's intention to take the proposed action objects to the action within ninety days after notice has been given. The objection must be by written notice to the trustee.

(B) If there is no trustee of the trust other than an interested trustee, the interested trustee or, where two or more persons are acting as trustee and are interested trustees, a majority of the interested trustees may, in its sole discretion and without court approval:

(1) convert an income trust to a total return unitrust;

(2) reconvert a total return unitrust to an income trust; or

(3) change the percentage used to calculate the unitrust amount or the method used to determine the fair market value of the trust if all of the following apply:

(a) The trustee adopts a written policy for the trust providing:

(i) in the case of a trust being administered as an income trust, that future distributions from the trust will be unitrust amounts rather than net income as determined pursuant to the South Carolina Uniform Principal and Income Act;

(ii) in the case of a trust being

administered as a total return unitrust, that future distributions from the trust will be net income as determined pursuant to the South Carolina Uniform Principal and Income Act rather than unitrust amounts, or

(iii) that the percentage used to calculate the unitrust amount or the method used to determine the fair market value of the trust will be changed as stated in the policy.

(b) The trustee appoints a disinterested person who, in its sole discretion but acting in a fiduciary capacity, determines for the trustee:

(i) the percentage to be used to calculate the unitrust amount;

(ii) the method to be used in determining the fair market value of the trust; and

(iii) which assets, if any, are to be excluded in determining the unitrust amount.

(c) The trustee gives written notice of its intention to take the action, including copies of the written policy and Sections 62-7-904B through 62-7-904P and the determinations of the disinterested person to:

(i) the settlor of the trust, if living; and

(ii) all persons who are the qualified beneficiaries of the trust at the time of the giving of the notice. If a qualified beneficiary is under a legal disability, notice must be given to the representative of the qualified beneficiary if a representative is available without court order.

(d) There is at least:

(i) one qualified beneficiary described in Section 62-7-103(12)(A) or (B) or a representative of a beneficiary so described; and

(ii) one qualified beneficiary described in Section 62-7-103(12)(C) or a representative of a qualified beneficiary so described.

(e) No person receiving notice of the trustee's intention to take the proposed action of the trustee objects to the action or to the determination of the disinterested person within ninety days after notice has been given. The objection must be by written instrument delivered to the trustee.

(C) A trustee may act under subsection (A) or (B) of this section with respect to a trust for which both income and principal have been set aside permanently for charitable purposes under the governing instrument and for which a federal estate or gift tax deduction has been taken, if all of the following apply:

(1) Instead of sending written notice to the persons described in subsection (A)(3)(b) or subsection (B)(3)(b), as the case may be, the trustee shall send written notice to each charitable organization expressly designated to receive the income of the trust under the governing instrument and, if no charitable organization is expressly designated to receive all of the income of the trust under the governing instrument, to the Attorney General of this State.

(2) Subsection (A)(3)(d) or subsection (B)(3)(d) of this subsection, as the case may be, does not apply to this action.

(3) In each taxable year, the trustee shall distribute the greater of the unitrust amount or the amount required by Section 4942 of the Code.

(D) The provisions of Section 62-7-109 regarding notices and the sending of documents to persons under this article shall apply for purposes of notices and the sending of documents under this section.

Section 62-7-904D. (A) If a trustee desires to:

(1) convert an income trust to a total return unitrust;

(2) reconvert a total return unitrust to an income trust; or

(3) change the percentage used to calculate the unitrust amount or the method used to determine the fair market value of the trust assets but does not have the ability to or elects not to do it under Section 62-7-904C, the trustee may petition the court for an order as the trustee considers appropriate. If there is only one trustee of the trust and the trustee is an interested trustee or if there are two or more trustees of the trust and a majority of them are

interested trustees, the court, in its own discretion or on the petition of the trustee or trustees or any person interested in the trust, may appoint a disinterested person who, acting in a fiduciary capacity, shall present information to the court as necessary to enable the court to make its determinations under Sections 62-7-904B through 62-7-904P.

(B) A qualified beneficiary or a representative of a qualified beneficiary may request the trustee to:

(1) convert an income trust to a total return unitrust;

(2) reconvert a total return unitrust to an income trust; or

(3) change the percentage used to calculate the unitrust amount or the method used to determine the fair market value of the trust. If the trustee does not take the action requested, the qualified beneficiary or a representative of the qualified beneficiary may petition the court to order the trustee to take the action.

(C) All proceedings under this section must be conducted as provided in Part 2 of this article.

Section 62-7-904E. (A) The fair market value of the trust assets must be determined at least annually, using a valuation date selected by the trustee in its discretion. The trustee, in its discretion, may use an average of the fair market value on the same valuation date for the current fiscal year and not more than three preceding fiscal years, if the use of this average appears desirable to the trustee to reduce the impact of fluctuations in market value on the unitrust amount. Assets for which a fair market value cannot be readily ascertained must be valued using valuation methods as are considered reasonable and appropriate by the trustee. Assets, such as a residence or tangible personal property, used by the trust beneficiary may be excluded by the trustee from the fair market value for computing the unitrust amount.

(B) The percentage to be used by the trustee in determining the unitrust amount must be a

reasonable current return from the trust, but not less than three percent nor more than five percent, taking into account the intentions of the settlor of the trust as expressed in the terms of the trust, the needs of the beneficiaries, general economic conditions, projected current earnings and appreciation for the trust assets, and projected inflation and its impact on the trust.

(C) Following the conversion of an income trust to a total return unitrust, the trustee:

(1) shall consider the unitrust amount as paid from net accounting income determined as if the trust were not a unitrust;

(2) shall then consider the unitrust amount as paid from ordinary income not allocable to net accounting income;

(3) may, in the trustee's discretion, consider the unitrust amount as paid from net short-term gain described in Section 1222(5) of the Code and then from net long-term capital gain described in Section 1222(7) of the Code so long as the discretionary power is exercised consistently and in a reasonable and impartial manner, but the amount so paid from net capital gains may not be greater than the excess of the unitrust amount over the amount of distributable net income as defined in Section 643(a) of the Code without regard to Section 1.643(a)-3(b) of the Treasury Regulations, as amended from time to time; and

(4) shall then consider the unitrust amount as coming from the principal of the trust.

Section 62-7-904F. In administering a total return unitrust, the trustee may, in its sole discretion but subject to the terms of the trust, determine:

(1) the effective date of the conversion;

(2) the timing of distributions, including provisions for prorating a distribution for a short year in which a beneficiary's right to payments commences or ceases;

(3) whether distributions are to be made in cash or in kind or partly in cash and partly in kind;

- (4) if the trust is reconverted to an income trust, the effective date of the reconversion; and
(5) any other administrative issues as may be necessary or appropriate to carry out the purposes of Sections 62-7-904B through 62-7-904P.

Section 62-7-904G. Conversion to a total return unitrust under Sections 62-7-904B through 62-7-904P does not affect any other provision of the terms of the trust, if any, regarding distributions of principal. For purposes of Sections 62-7-904B through 62-7-904P, the distribution of a unitrust amount is considered a distribution of income and not of principal.

Section 62-7-904H. No trustee or disinterested person who in good faith takes or fails to take any action under Sections 62-7-904B through 62-7-904P is liable to any person affected by the action or inaction, regardless of whether the person received written notice as provided in Sections 62-7-904B through 62-7-904P and regardless of whether the person was under a legal disability at the time of the delivery of the notice. The exclusive remedy for any person affected by such action or inaction is to obtain an order of the court directing the trustee to:

- (1) convert an income trust to a total return unitrust;
- (2) reconvert from a total return unitrust to an income trust; or
- (3) change the percentage used to calculate the unitrust amount.

Section 62-7-904I. Sections 62-7-904B through 62-7-904P apply to all trusts in existence on, or created after the effective date of Sections 62-7-904A through 62-7-904P unless:

- (1) the governing instrument contains a provision clearly expressing the settlor's intention that the current beneficiary or beneficiaries are to receive an amount other than a reasonable current return from the trust;

(2) the trust is a trust described in Section 170(f)(2)(B), Section 664(d), Section 2702(a)(3), or Section 2702(b) of the Code;

(3) the trust is a trust under which any amount is, or has been in the past, set aside permanently for charitable purposes unless the income from the trust also is devoted permanently to charitable purposes; or

(4) the governing instrument expressly prohibits use of Sections 62-7-904B through 62-7-904P by specific reference to Sections 62-7-904B through 62-7-904P or expressly states the settlor's intent that net income not be calculated as a unitrust amount.

A provision in the terms of the trust that 'the provisions of Sections 62-7-904B through 62-7-904P of this part or any corresponding provision of future law, must not be used in the administration of this trust,' or 'the trustee shall not determine the distributions to the income beneficiary as a unitrust amount,' or similar words reflecting that intent is sufficient to preclude the use of Sections 62-7-904B through 62-7-904P.

Section 62-7-904J. RESERVED

Section 62-7-904K. RESERVED

Section 62-7-904L. RESERVED

Section 62-7-904M.(A) The unitrust amount to be distributed by the express total return unitrust may be determined by the terms of the unitrust governing instrument by reference to the net fair market value of the trust's assets determined annually or averaged on a multiple-year basis.

(B) The terms of an express total return unitrust governing instrument may provide that:

(1) any assets of such a unitrust for which a fair market value cannot be readily ascertained must be valued using valuation methods that the trustee considers reasonable and appropriate;

(2) any assets of such a unitrust, such as a residence property or tangible personal property,

used by the trust beneficiary entitled to the unitrust amount may be excluded by the trustee from the net fair market value for computing the unitrust amount.

Section 62-7-904N. The distribution from an express total return unitrust of a unitrust amount equal to a fixed percentage of not less than three percent nor more than five percent reasonably apportions between the income beneficiaries and the remainder of the total return of an express total return unitrust.

Section 62-7-904O. (A) The terms of an express total return unitrust governing instrument may provide the method similar to the method provided under Section 62-7-904C for changing the unitrust percentage or for converting from a unitrust to an income trust or for a reconversion of an income trust to a unitrust, or for all of these actions.

(B) If the terms of an express total return unitrust governing instrument do not specifically or by reference to Section 62-7-904C grant a power to the trustee to change the unitrust percentage or change to an income trust, the trustee shall not have that power.

Section 62-7-904P. Unless the terms of the express total return unitrust governing instrument specifically provide otherwise, the trustee:

(A) shall consider the unitrust amount as paid from net accounting income determined as if the trust were not a unitrust;

(B) shall then consider the unitrust amount as paid from ordinary income not allocable to net accounting income;

(C) may, in the trustee's discretion, consider the unitrust amount as paid from net short-term gain described in Section 1222(5) of the Code and then from net long-term capital gain described in Section 1222(7) of the Code so long as this discretionary power is exercised consistently and in a reasonable and impartial manner, but the amount so paid from net capital

SECTION 62-7-905. Determinations of income and principal; distributions upon death of decedent or end of an income interest in a trust.

After a decedent dies, in the case of an estate, or after an income interest in a trust ends, a fiduciary:

(1) of an estate or of a terminating income interest shall determine the amount of net income and net principal receipts received from property specifically given to a beneficiary pursuant to Sections 62-7-907 through 62-7-930 which apply to trustees and the provisions of item (5). The fiduciary shall distribute the net income and net principal receipts to the beneficiary who is to receive the specific property;

(2) shall determine the remaining net income of a decedent's estate or a terminating income interest pursuant to Sections 62-7-907 through 62-7-930 which apply to trustees and by:

(a) including in net income all income from property used to discharge liabilities;

(b) paying from income or principal, in the fiduciary's discretion, fees of attorneys, accountants, and fiduciaries, court costs and other expenses of administration, and interest on death taxes; except that the fiduciary may pay those expenses from income of property passing to a trust for which the fiduciary claims an estate tax marital or charitable deduction only to the extent that the payment of those expenses from income does not cause the reduction or loss of the deduction; and

(c) paying from principal all other

gains may not be greater than the excess of the unitrust amount over the amount of distributable net income as defined in Section 643(a) of the Code without regard to Section 1.643(a)-3(b) of the Treasury Regulations; and

(D) shall then consider the unitrust amount as coming from the principal of the trust.

SECTION 62-7-905.

After a decedent dies, in the case of an estate, or after an income interest in a trust ends, a fiduciary:

(1) of an estate or of a terminating income interest shall determine the amount of net income and net principal receipts received from property specifically given to a beneficiary pursuant to Sections 62-7-907 through 62-7-930 which apply to trustees and the provisions of item (5). The fiduciary shall distribute the net income and net principal receipts to the beneficiary who is to receive the specific property;

(2) shall determine the remaining net income of a decedent's estate or a terminating income interest pursuant to Sections 62-7-907 through 62-7-930 which apply to trustees and by:

(a) including in net income all income from property used to discharge liabilities;

(b) paying from income or principal, in the fiduciary's discretion, fees of attorneys, accountants, and fiduciaries, court costs and other expenses of administration, and interest on death taxes; except that the fiduciary may pay those expenses from income of property passing to a trust for which the fiduciary claims an estate tax marital or charitable deduction only to the extent that the payment of those expenses from income does not cause the reduction or loss of the deduction; and

(c) paying from principal all other disbursements made or incurred in connection

disbursements made or incurred in connection with the settlement of a decedent's estate or the winding up of a terminating income interest, including debts, funeral expenses, disposition of remains, family allowances, and death taxes and related penalties that are apportioned to the estate or terminating income interest by the will, the terms of the trust, or applicable law;

(3) shall distribute to a beneficiary who receives a pecuniary amount outright the rate of interest or other amount provided by the will or the terms of the trust. If the will or the terms of the trust provide no interest amount, the beneficiary of a pecuniary amount outright shall receive no interest or other income on the bequest for one year after the first appointment of a personal representative. Beginning one year after the first appointment of a personal representative, and notwithstanding any other provision of law to the contrary, the beneficiary of a pecuniary amount outright must be treated as any other beneficiary under item (4). If a beneficiary is to receive a pecuniary amount outright from a trust after an income interest ends and no interest or other amount is provided for by the terms of the trust, the fiduciary shall treat the pecuniary amount as if it were required to be paid under a will and as if the payment were being made beginning one year after the first appointment of a personal representative;

(4) shall distribute the net income remaining after distributions required by item (3) in the manner pursuant to Section 62-7-906 to all other beneficiaries, including a beneficiary who receives a pecuniary amount in trust, even if the beneficiary holds an unqualified power to withdraw assets from the trust or other presently exercisable general power of appointment over the trust; and

(5) may not reduce principal or income receipts from property described in item (1) because of a payment pursuant to Sections 62-7-924 and 62-7-925 to the extent that the will, the terms of the trust, or applicable law

with the settlement of a decedent's estate or the winding up of a terminating income interest, including debts, funeral expenses, disposition of remains, family allowances, and death taxes and related penalties that are apportioned to the estate or terminating income interest by the will, the terms of the trust, or applicable law;

(3) shall distribute to a beneficiary who receives a pecuniary amount outright the rate of interest or other amount provided by the will or the terms of the trust. If the will or the terms of the trust provide no interest amount, the beneficiary of a pecuniary amount outright shall receive no interest or other income on the bequest for one year after the first appointment of a personal representative. Beginning one year after the first appointment of a personal representative, and notwithstanding any other provision of law to the contrary, the beneficiary of a pecuniary amount outright must be treated as any other beneficiary under item (4). If a beneficiary is to receive a pecuniary amount outright from a trust after an income interest ends and no interest or other amount is provided for by the terms of the trust, the fiduciary shall treat the pecuniary amount as if it were required to be paid under a will and as if the payment were being made beginning one year after the first appointment of a personal representative;

(4) shall distribute the net income remaining after distributions required by item (3) in the manner pursuant to Section 62-7-906 to all other beneficiaries, including a beneficiary who receives a pecuniary amount in trust, even if the beneficiary holds an unqualified power to withdraw assets from the trust or other presently exercisable general power of appointment over the trust; and

(5) may not reduce principal or income receipts from property described in item (1) because of a payment pursuant to Sections 62-7-924 and 62-7-925 to the extent that the will, the terms of the trust, or applicable law requires the fiduciary to make the payment from assets other than the property or to the extent that the fiduciary recovers or expects to recover

requires the fiduciary to make the payment from assets other than the property or to the extent that the fiduciary recovers or expects to recover the payment from a third party. The net income and principal receipts from the property are determined by including all of the amounts the fiduciary receives or pays with respect to the property, whether those amounts accrued or became due before, on, or after the date of a decedent's death or an income interest's terminating event, and by making a reasonable provision for amounts that the fiduciary believes the estate or terminating income interest may become obligated to pay after the property is distributed.

the payment from a third party. The net income and principal receipts from the property are determined by including all of the amounts the fiduciary receives or pays with respect to the property, whether those amounts accrued or became due before, on, or after the date of a decedent's death or an income interest's terminating event, and by making a reasonable provision for amounts that the fiduciary believes the estate or terminating income interest may become obligated to pay after the property is distributed.

REPORTER'S COMMENT

Terminating income interests and successive income interests. A trust that provides for a single income beneficiary and an outright distribution of the remainder ends when the income interest ends. A more complex trust may have a number of income interests, either concurrent or successive, and the trust will not necessarily end when one of the income interests ends. For that reason, the Act speaks in terms of income interests ending and beginning rather than trusts ending and beginning. When an income interest in a trust ends, the trustee's powers continue during the winding up period required to complete its administration. A terminating income interest is one that has ended but whose administration is not complete.

If two or more people are given the right to receive specified percentages or fractions of the income from a trust concurrently and one of the concurrent interests ends, e.g., when a beneficiary dies, the beneficiary's income interest ends but the trust does not. Similarly, when a trust with only one income beneficiary ends upon the beneficiary's death, the trust instrument may provide that part or all of the trust assets shall continue in trust for another income beneficiary. While it is common to think and speak of this (and even to characterize it in a trust instrument) as a "new" trust, it is a continuation of the original trust for a remainder beneficiary who has an income interest in the

trust assets instead of the right to receive them outright. For purposes of this Act, this is a successive income interest in the same trust. The fact that a trust may or may not end when an income interest ends is not significant for purposes of this Act.

If the assets that are subject to a terminating income interest pass to another trust because the income beneficiary exercises a general power of appointment over the trust assets, the recipient trust would be a new trust; and if they pass to another trust because the beneficiary exercises a nongeneral power of appointment over the trust assets, the recipient trust might be a new trust in some States (see 5A Austin W. Scott & William F. Fratcher, *The Law of Trusts* Sec 640, at 483 (4th ed. 1989)); but for purposes of this Act a new trust created in these circumstances is also a successive income interest.

Gift of a pecuniary amount. Section 62-7-905(3) and (4) provide different rules for an outright gift of a pecuniary amount and a gift in trust of a pecuniary amount; this is the same approach used in Section 62-7-408(b)(2) of the 1963 SC Act.

Interest on pecuniary amounts. Section 62-7-905(3) provides that the beneficiary of an outright pecuniary amount is to receive the interest or other amount provided by applicable law if there is no provision in the will or the terms of the trust. Many States have no applicable law that provides for interest or some other amount to be paid on an outright pecuniary gift under an inter vivos trust; this section provides that in such a case the interest or other amount to be paid shall be the same as the interest or other amount required to be paid on testamentary pecuniary gifts. This provision is intended to accord gifts under inter vivos instruments the same treatment as testamentary gifts. The various state authorities that provide for the amount that a beneficiary of an outright pecuniary amount is entitled to receive are collected in Richard B. Covey, *Marital Deduction and Credit Shelter Dispositions and the Use of Formula Provisions*, App. B (4th ed.

<p>SECTION 62-7-906. Determination and distribution of net income.</p> <p>(A) Each beneficiary described in Section 62-7-905(4) is entitled to receive a portion of the net income equal to his fractional interest in undistributed principal assets, using values as of the distribution date. If a fiduciary makes more than one distribution of assets to beneficiaries to whom this section applies, each beneficiary, including one who does not receive part of the distribution, is entitled, as of each distribution date, to the net income the fiduciary has received after the date of death or terminating event or earlier distribution date but has not distributed as of the current distribution date.</p> <p>(B) In determining a beneficiary's share of net income, the:</p> <p>(1) beneficiary is entitled to receive a portion of the net income equal to his fractional interest in the undistributed principal assets immediately before the distribution date,</p>	<p>1997).</p> <p>Administration expenses and interest on death taxes. Under Section 62-7-905(2)(b) a fiduciary may pay administration expenses and interest on death taxes from either income or principal. An advantage of permitting the fiduciary to choose the source of the payment is that, if the fiduciary's decision is consistent with the decision to deduct these expenses for income tax purposes or estate tax purposes, it eliminates the need to adjust between principal and income that may arise when, for example, an expense that is paid from principal is deducted for income tax purposes or an expense that is paid from income is deducted for estate tax purposes.</p> <p>Interest on Estate Taxes. Under the 1963 Act, Section 62-7-418(5) charges interest on estate and inheritance taxes to principal. The 1931 Act has no provision. Section 62-7-925(3) of this Act provides that, except to the extent provided in Section 62-7-905(2)(b) or (c), all interest must be paid from income.</p> <p>SECTION 62-7-906.</p> <p>(A) Each beneficiary described in Section 62-7-905(4) is entitled to receive a portion of the net income equal to his fractional interest in undistributed principal assets, using values as of the distribution date. If a fiduciary makes more than one distribution of assets to beneficiaries to whom this section applies, each beneficiary, including one who does not receive part of the distribution, is entitled, as of each distribution date, to the net income the fiduciary has received after the date of death or terminating event or earlier distribution date but has not distributed as of the current distribution date.</p> <p>(B) In determining a beneficiary's share of net income, the:</p> <p>(1) beneficiary is entitled to receive a portion of the net income equal to his fractional interest in the undistributed principal assets immediately before the distribution date, including assets that later may be sold to meet</p>
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including assets that later may be sold to meet principal obligations.

(2) fractional interest of the beneficiary in the undistributed principal assets must be calculated without regard to property specifically given to a beneficiary and property required to pay pecuniary amounts not in trust.

(3) fractional interest of the beneficiary in the undistributed principal assets must be calculated on the basis of the aggregate value of those assets as of the distribution date without reducing the value by any unpaid principal obligation; and

(4) distribution date for purposes of this section may be the date as of which the fiduciary calculates the value of the assets if that date is reasonably near the date on which assets are actually distributed.

(C) If a fiduciary does not distribute all of the collected but undistributed net income to each person as of a distribution date, the fiduciary shall maintain appropriate records showing the interest of each beneficiary in that net income.

(D) A trustee may apply the provisions of this section, to the extent that the trustee considers it appropriate, to net gain or loss realized after the date of death or terminating event or earlier distribution date from the disposition of a principal asset if this section applies to the income from the asset.

principal obligations.

(2) fractional interest of the beneficiary in the undistributed principal assets must be calculated without regard to property specifically given to a beneficiary and property required to pay pecuniary amounts not in trust.

(3) fractional interest of the beneficiary in the undistributed principal assets must be calculated on the basis of the aggregate value of those assets as of the distribution date without reducing the value by any unpaid principal obligation; and

(4) distribution date for purposes of this section may be the date as of which the fiduciary calculates the value of the assets if that date is reasonably near the date on which assets are actually distributed.

(C) If a fiduciary does not distribute all of the collected but undistributed net income to each person as of a distribution date, the fiduciary shall maintain appropriate records showing the interest of each beneficiary in that net income.

(D) A trustee may apply the provisions of this section, to the extent that the trustee considers it appropriate, to net gain or loss realized after the date of death or terminating event or earlier distribution date from the disposition of a principal asset if this section applies to the income from the asset.

REPORTER'S COMMENT

Relationship to Prior Acts. Section 62-7-906 retains the concept in Section 62-7-408(2) of the 1963 SC Act that the residuary legatees of estates are to receive net income earned during the period of administration on the basis of their proportionate interests in the undistributed assets when distributions are made. It changes the basis for determining their proportionate interests by using asset values as of a date reasonably near the time of distribution instead of inventory values; it extends the application of these rules to distributions from terminating trusts; and it extends these rules to gain or loss realized from the disposition of assets during

<p>SECTION 62-7-907. Beginning and end of income interests.</p> <p>(A) An income beneficiary is entitled to net income from the date on which the income interest begins. An income interest begins on the date specified in the terms of the trust or, if no date is specified, on the date an asset becomes subject to a trust or successive income interest.</p> <p>(B) An asset becomes subject to a trust on the date:</p> <p>(1) it is transferred to the trust, in the case of an asset that is transferred to a trust during the transferor's life;</p> <p>(2) the testator dies, in the case of an asset that becomes subject to a trust by reason of a will, even if there is an intervening period of administration of the estate; or</p> <p>(3) the individual dies, in the case of an asset that is transferred to a fiduciary by a third party because of the death of the individual.</p> <p>(C) An asset becomes subject to a successive income interest on the day after the preceding income interest ends, as determined pursuant to subsection (D), even if there is an intervening period of administration to wind up the preceding income interest.</p> <p>(D) An income interest ends on the day before an income beneficiary dies or another terminating event occurs or on the last day of a period during which there is no beneficiary to whom a trustee may distribute income.</p>	<p>administration, an omission in the 1962 Act that has been noted by several commentators. See, e.g., Richard B. Covey, Marital Deduction and Credit Shelter Dispositions and the Use of Formula Provisions 91 (4th ed. 1998); Thomas H. Cantrill, Fractional or Percentage Residuary Bequests: Allocation of Postmortem Income, Gain and Unrealized Appreciation, 10 Prob. Notes 322, 327 (1985).</p> <p>SECTION 62-7-907.</p> <p>(A) An income beneficiary is entitled to net income from the date on which the income interest begins. An income interest begins on the date specified in the terms of the trust or, if no date is specified, on the date an asset becomes subject to a trust or successive income interest.</p> <p>(B) An asset becomes subject to a trust on the date:</p> <p>(1) it is transferred to the trust, in the case of an asset that is transferred to a trust during the transferor's life;</p> <p>(2) the testator dies, in the case of an asset that becomes subject to a trust by reason of a will, even if there is an intervening period of administration of the estate; or</p> <p>(3) the individual dies, in the case of an asset that is transferred to a fiduciary by a third party because of the death of the individual.</p> <p>(C) An asset becomes subject to a successive income interest on the day after the preceding income interest ends, as determined pursuant to subsection (D), even if there is an intervening period of administration to wind up the preceding income interest.</p> <p>(D) An income interest ends on the day before an income beneficiary dies or another terminating event occurs or on the last day of a period during which there is no beneficiary to whom a trustee may distribute income.</p> <p>REPORTER'S COMMENT</p>
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<p>SECTION 62-7-908. Allocation of income receipts and disbursements.</p> <p>(A) A trustee shall allocate an income receipt or disbursement, other than one subject to Section 62-7-905(1), to principal if its due date occurs before a decedent dies in the case of an estate or before an income interest begins in the case of a trust or successive income interest.</p> <p>(B) A trustee shall allocate an income receipt or disbursement to income if its due date occurs on or after the date on which a decedent dies or an income interest begins and it is a periodic due date. An income receipt or disbursement must be treated as accruing from day to day if its due date is not periodic or it has no due date. The portion of the receipt or disbursement accruing before the date on which a decedent dies or an income interest begins must be allocated to principal and the balance must be allocated to income.</p> <p>(C) An item of income or an obligation is due on the date the payer is required to make a payment. If a payment date is not stated, there is no due date for the purposes of this part. Distributions to shareholders or other owners from an entity subject to Section</p>	<p>Period during which there is no beneficiary. The purpose of the second part of subsection (D) is to provide that, at the end of a period during which there is no beneficiary to whom a trustee may distribute income, the trustee must apply the same apportionment rules that apply when a mandatory income interest ends. This provision would apply, for example, if a settlor creates a trust for grandchildren before any grandchildren are born. When the first grandchild is born, the period preceding the date of birth is treated as having ended, followed by a successive income interest, and the apportionment rules in Sections 62-7-908 and 909 apply accordingly if the terms of the trust do not contain different provisions.</p> <p>SECTION 62-7-908.</p> <p>(A) A trustee shall allocate an income receipt or disbursement, other than one subject to Section 62-7-905(1), to principal if its due date occurs before a decedent dies in the case of an estate or before an income interest begins in the case of a trust or successive income interest.</p> <p>(B) A trustee shall allocate an income receipt or disbursement to income if its due date occurs on or after the date on which a decedent dies or an income interest begins and it is a periodic due date. An income receipt or disbursement must be treated as accruing from day to day if its due date is not periodic or it has no due date. The portion of the receipt or disbursement accruing before the date on which a decedent dies or an income interest begins must be allocated to principal and the balance must be allocated to income.</p> <p>(C) An item of income or an obligation is due on the date the payer is required to make a payment. If a payment date is not stated, there is no due date for the purposes of this part. Distributions to shareholders or other owners from an entity subject to Section 62-7-910 are considered due on the date fixed by the entity for determining who is entitled to receive the</p>
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62-7-910 are considered due on the date fixed by the entity for determining who is entitled to receive the distribution or, if no date is fixed, on the declaration date for the distribution. A due date is periodic for receipts or disbursements that must be paid at regular intervals under a lease or an obligation to pay interest or if an entity customarily makes distributions at regular intervals.

distribution or, if no date is fixed, on the declaration date for the distribution. A due date is periodic for receipts or disbursements that must be paid at regular intervals under a lease or an obligation to pay interest or if an entity customarily makes distributions at regular intervals.

REPORTER'S COMMENT

Prior Acts. Professor Bogert stated that "Section 4 of the [1962] Act makes a change with respect to the apportionment of the income of trust property not due until after the trust began but which accrued in part before the commencement of the trust. It treats such income as to be credited entirely to the income account in the case of a living trust, but to be apportioned between capital and income in the case of a testamentary trust. The [1931] Act apportions such income in the case of both types of trusts, except in the case of corporate dividends." George G. Bogert, *The Revised Uniform Principal and Income Act*, 38 *Notre Dame Law* 50, 52 (1962). The 1962 Act also provided that an asset passing to an inter vivos trust by a bequest in the settlor's will is governed by the rule that applies to a testamentary trust, so that different rules apply to assets passing to an inter vivos trust depending upon whether they were transferred to the trust during the settlor's life or by his will.

Having several different rules that apply to similar transactions is confusing. In order to simplify administration, Section 62-7-908 of this Act applies the same rule to inter vivos trusts (revocable and irrevocable), testamentary trusts, and assets that become subject to an inter vivos trust by a testamentary bequest.

Periodic payments. Under Section 62-7-908 a periodic payment is principal if it is due but unpaid before a decedent dies or before an asset becomes subject to a trust, but the next payment is allocated entirely to income and is not apportioned. Thus, periodic receipts such as rents, dividends, interest, and annuities, and

disbursements such as the interest portion of a mortgage payment, are not apportioned. This is the original common law rule. Edwin A. Howes, Jr., *The American Law Relating to Income and Principal* 70 (1905). In trusts in which a surviving spouse is dependent upon a regular flow of cash from the decedent's securities portfolio, this rule will help to maintain payments to the spouse at the same level as before the settlor's death. Under the 1962 Act, the pre-death portion of the first periodic payment due after death was apportioned to principal in the case of a testamentary trust or securities bequeathed by will to an inter vivos trust.

Nonperiodic payments. Under the second sentence of Section 62-7-908(B) interest on an obligation that does not provide a due date for the interest payment, such as interest on an income tax refund, would be apportioned to principal to the extent it accrues before a person dies or an income interest begins unless the obligation is specifically given to a devisee or remainder beneficiary, in which case all of the accrued interest passes under Section 62-7-905(1) to the person who receives the obligation. The same rule applies to interest on an obligation that has a due date but does not provide for periodic payments. If there is no stated interest on the obligation, such as a zero coupon bond, and the proceeds from the obligation are received more than one year after it is purchased or acquired by the trustee, the entire amount received is principal under Section 62-7-915.

SECTION 62-7-909. Undistributed income.

(A) In this section, "undistributed income" means net income received before the date on which an income interest ends. The term does not include an item of income or expense that is due or accrued or net income that has been added or must be added to principal under the terms of the trust.

(B) When a mandatory income interest ends,

SECTION 62-7-909.

(A) In this section, 'undistributed income' means net income received before the date on which an income interest ends. The term does not include an item of income or expense that is due or accrued or net income that has been added or must be added to principal under the terms of the trust.

(B) When a mandatory income interest ends,

the trustee shall pay to a mandatory income beneficiary who survives that date, or the estate of a deceased mandatory income beneficiary whose death causes the interest to end, the beneficiary's share of the undistributed income that is not disposed of under the terms of the trust, unless the beneficiary has an unqualified power to revoke more than five percent of the trust immediately before the income interest ends. In that case, the undistributed income from the portion of the trust that may be revoked must be added to principal.

(C) When the obligation of a trustee to pay a fixed annuity or a fixed fraction of the value of the trust assets ends, the trustee shall prorate the final payment if, and to the extent, required by applicable law to accomplish a purpose of the trust or its settlor relating to income, gift, estate, or other tax requirements.

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(C) When the obligation of a trustee to pay a fixed annuity or a fixed fraction of the value of the trust assets ends, the trustee shall prorate the final payment if, and to the extent, required by applicable law to accomplish a purpose of the trust or its settlor relating to income, gift, estate, or other tax requirements.

REPORTER'S COMMENT

Prior Acts. Both the 1931 Act (Section 4) and the 1962 Act (Section 4(d)) provided that a deceased income beneficiary's estate is entitled to the undistributed income. The ULC Drafting Committee for the 1997 Act concluded that this is probably not what most settlors would want, and that, with respect to undistributed income, most settlors would favor the income beneficiary first, the remainder beneficiaries second, and the income beneficiary's heirs last, if at all. However, it decided not to eliminate this provision to avoid causing disputes about whether the trustee should have distributed collected cash before the income beneficiary died.

Accrued periodic payments. Under the prior Acts, an income beneficiary or his estate is entitled to receive a portion of any payments, other than dividends, that are due or that have accrued when the income interest terminates. The last sentence of subsection (A) changes that rule by providing that such items are not included in undistributed income. The items affected include periodic payments of interest,

rent, and dividends, as well as items of income that accrue over a longer period of time; the rule also applies to expenses that are due or accrued.

Example - Accrued periodic payments. The rules in Sections 62-7-908 and 909 work in the following manner: Assume that a periodic payment of rent that is due on July 20 has not been paid when an income interest ends on July 30; the successive income interest begins on July 31, and the rent payment that was due on July 20 is paid on August 3. Under Section 62-7-908(A), the July 20 payment is added to the principal of the successive income interest when received. Under Section 62-7-909(B), the entire periodic payment of rent that is due on August 20 is income when received by the successive income interest. Under Section 62-7-909, neither the income beneficiary of the terminated income interest nor the beneficiary's estate is entitled to any part of either the July 20 or the August 20 payments because neither one was received before the income interest ended on July 30. The same principles apply to expenses of the trust.

Beneficiary with an unqualified power to revoke. The requirement in subsection (B) to pay undistributed income to a mandatory income beneficiary or his estate does not apply to the extent the beneficiary has an unqualified power to revoke more than five percent of the trust immediately before the income interest ends. Without this exception, subsection (B) would apply to a revocable living trust whose settlor is the mandatory income beneficiary during her lifetime, even if her will provides that all of the assets in the probate estate are to be distributed to the trust.

If a trust permits the beneficiary to withdraw all or a part of the trust principal after attaining a specified age and the beneficiary attains that age but fails to withdraw all of the principal that he is permitted to withdraw, a trustee is not required to pay him or his estate the undistributed income attributable to the portion of the principal that he left in the trust. The assumption underlying this rule is that the

<p>SECTION 62-7-910. Allocation of receipts from an entity to principal or income.</p> <p>(A) In this section, “entity” means a corporation, partnership, limited liability company, regulated investment company, real estate investment trust, common trust fund, or other organization in which a trustee has an interest other than a trust or estate subject to Section 62-7-911, a business or activity to which Section 62-7-912 applies, or an asset-backed security to which Section 62-7-924 applies.</p> <p>(B) Except as otherwise provided in this section, a trustee shall allocate to income money received from an entity.</p> <p>(C) A trustee shall allocate the following receipts from an entity to principal:</p> <ol style="list-style-type: none"> (1) property other than money; (2) money received in one distribution or a series of related distributions in exchange for part or all of a trust’s interest in the entity; (3) money received in total or partial liquidation of the entity; and (4) money received from an entity that is a regulated investment company or a real estate investment trust if the money distributed is a capital gain dividend for federal income tax purposes. <p>(D) Money is received in partial liquidation:</p> <ol style="list-style-type: none"> (1) to the extent that the entity, at or near the time of a distribution, indicates that it is a distribution in partial liquidation; or (2) if the total amount of money and property 	<p>beneficiary has either provided for the disposition of the trust assets (including the undistributed income) by exercising a power of appointment that he has been given or has not withdrawn the assets because he is willing to have the principal and undistributed income be distributed under the terms of the trust. If the beneficiary has the power to withdraw 25% of the trust principal, the trustee must pay to him or his estate the undistributed income from the 75% that he cannot withdraw.</p> <p>SECTION 62-7-910.</p> <p>(A) In this section, ‘entity’ means a corporation, partnership, limited liability company, regulated investment company, real estate investment trust, common trust fund, or other organization in which a trustee has an interest other than a trust or estate subject to Section 62-7-911, a business or activity to which Section 62-7-912 applies, or an asset-backed security to which Section 62-7-924 applies.</p> <p>(B) Except as otherwise provided in this section, a trustee shall allocate to income money received from an entity.</p> <p>(C) A trustee shall allocate the following receipts from an entity to principal:</p> <ol style="list-style-type: none"> (1) property other than money; (2) money received in one distribution or a series of related distributions in exchange for part or all of a trust’s interest in the entity; (3) money received in total or partial liquidation of the entity; and (4) money received from an entity that is a regulated investment company or a real estate investment trust if the money distributed is a capital gain dividend for federal income tax purposes. <p>(D) Money is received in partial liquidation:</p> <ol style="list-style-type: none"> (1) to the extent that the entity, at or near the time of a distribution, indicates that it is a distribution in partial liquidation; or (2) if the total amount of money and property received in a distribution or series of
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received in a distribution or series of related distributions is greater than twenty percent of the entity's gross assets of the entity, as shown by the year-end financial statements immediately preceding the initial receipt.

(E) Money is not received in partial liquidation, nor may it be taken into account pursuant to subsection (D)(2), to the extent that it does not exceed the amount of income tax that a trustee or beneficiary must pay on taxable income of the entity that distributes the money.

(F) A trustee may rely upon a statement made 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 board of directors or other person or group of persons authorized to exercise powers to pay money or transfer property comparable to those of a corporation's board of directors.

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REPORTER'S COMMENT

Entities to which Section 62-7-910 applies. The reference to partnerships in Section 62-7-910(A) is intended to include all forms of partnerships, including limited partnerships, limited liability partnerships, and variants that have slightly different names and characteristics from State to State. The section does not apply, however, to receipts from an interest in property that a trust owns as a tenant in common with one or more co-owners, nor would it apply to an interest in a joint venture if, under applicable law, the trust's interest is regarded as that of a tenant in common.

Capital gain dividends. If a capital gain dividend does not include any net short-term capital gain, cash received by a trust because of a net short-term capital gain is income under this Act.

Reinvested dividends. If a trustee elects (or continues an election made by its predecessor) to reinvest dividends in shares of stock of a distributing corporation or fund, whether evidenced by new certificates or entries on the books of the distributing entity, the new shares would be principal. Making or continuing such

an election would be equivalent to deciding under Section 62-7-904 to transfer income to principal in order to comply with Section 62-7-903(B). However, if the trustee makes or continues the election for a reason other than to comply with Section 62-7-903(B), e.g., to make an investment without incurring brokerage commissions, the trustee should transfer cash from principal to income in an amount equal to the reinvested dividends.

Distribution of property. The 1963 SC Act describes a number of types of property that would be principal if distributed by a corporation. This becomes unwieldy in a section that applies to both corporations and all other entities. By stating that principal includes the distribution of any property other than money, Section 62-7-910 embraces all of the items enumerated in the 1963 SC Act as well as any other form of nonmonetary distribution not specifically mentioned in that Act.

Partial liquidations. Under subsection (D)(1) any distribution designated by the entity as a partial liquidating distribution is principal regardless of the percentage of total assets that it represents. If a distribution exceeds twenty percent of the entity's gross assets, the entire distribution is a partial liquidation under subsection (D)(2) whether or not the entity describes it as a partial liquidation. In determining whether a distribution is greater than twenty percent of the gross assets, the portion of the distribution that does not exceed the amount of income tax that the trustee or a beneficiary must pay on the entity's taxable income is ignored.

Other large distributions. A cash distribution may be quite large (for example, more than ten percent but not more than twenty percent of the entity's gross assets) and have characteristics that suggest it should be treated as principal rather than income. For example, an entity may have received cash from a source other than the conduct of its normal business operations because it sold an investment asset; or because it sold a business asset other than one held for sale

<p>SECTION 62-7-911. Allocations of income and principal received from a trust or an estate.</p> <p>A trustee shall allocate to income an amount received as a distribution of income from a trust or an estate in which the trust has an interest other than a purchased interest, and shall allocate to principal an amount received as a distribution of principal from such a trust or estate. If a trustee purchases an interest in a trust that is an investment entity, or a decedent or donor transfers an interest in such a trust to a trustee, Section 62-7-910 or 62-7-924 applies to a receipt from the trust.</p>	<p>to customers in the normal course of its business and did not replace it; or it borrowed a large sum of money and secured the repayment of the loan with a substantial asset; or a principal source of its cash was from assets such as mineral interests, ninety percent of which would have been allocated to principal if the trust had owned the assets directly. In such a case, the trustee, after considering the total return from the portfolio as a whole and the income component of that return, may decide to exercise the power under Section 62-7-904(A) to make an adjustment between income and principal, subject to the limitations in Section 62-7-904(C).</p> <p>SECTION 62-7-911.</p> <p>A trustee shall allocate to income an amount received as a distribution of income from a trust or an estate in which the trust has an interest other than a purchased interest, and shall allocate to principal an amount received as a distribution of principal from such a trust or estate. If a trustee purchases an interest in a trust that is an investment entity, or a decedent or donor transfers an interest in such a trust to a trustee, Section 62-7-910 or 62-7-924 applies to a receipt from the trust.</p> <p>REPORTER’S COMMENT</p> <p>Terms of the distributing trust or estate. Under Section 62-7-903(A) a trustee is to allocate receipts in accordance with the terms of the recipient trust or, if there is no provision, in accordance with this Act. However, in determining whether a distribution from another trust or an estate is income or principal, the trustee should also determine what the terms of the distributing trust or estate say about the distribution - for example, whether they direct that the distribution, even though made from the</p>
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<p>SECTION 62-7-912. Separate accounting for a business activity.</p> <p>(A) If a trustee who conducts a business or other activity determines that it is in the best interest of all the beneficiaries to account separately for the business or activity instead of accounting for it as part of the general accounting records of the trust, the trustee may maintain separate accounting records for its transactions, whether or not its assets are segregated from other trust assets.</p> <p>(B) A trustee who accounts separately for a business or other activity may determine the extent to which its net cash receipts must be retained for working capital, the acquisition or replacement of fixed assets, and other reasonably foreseeable needs of the business or activity, and the extent to which the remaining net cash receipts are accounted for as principal or income in the trust's general accounting records. If a trustee sells assets of the business or other activity, other than in the ordinary course of the business or activity, the trustee shall account for the net amount</p>	<p>income of the distributing trust or estate, is to be added to principal of the recipient trust. Such a provision should override the terms of this Act, but if the terms of the recipient trust contain a provision requiring such a distribution to be allocated to income, the trustee may have to obtain a judicial resolution of the conflict between the terms of the two documents.</p> <p>Investment trusts. An investment entity to which the second sentence of this Section 62-7-911 applies includes a mutual fund, a common trust fund, a business trust or other entity organized as a trust for the purpose of receiving capital contributed by investors, investing that capital, and managing investment assets, including asset-backed security arrangements to which Section 62-7-924 applies. See John H. Langbein, <i>The Secret Life of the Trust: The Trust as an Instrument of Commerce</i>, 107 Yale L.J. 165 (1997).</p> <p>SECTION 62-7-912.</p> <p>(A) If a trustee who conducts a business or other activity determines that it is in the best interest of all the beneficiaries to account separately for the business or activity instead of accounting for it as part of the general accounting records of the trust, the trustee may maintain separate accounting records for its transactions, whether or not its assets are segregated from other trust assets.</p> <p>(B) A trustee who accounts separately for a business or other activity may determine the extent to which its net cash receipts must be retained for working capital, the acquisition or replacement of fixed assets, and other reasonably foreseeable needs of the business or activity, and the extent to which the remaining net cash receipts are accounted for as principal or income in the trust's general accounting records. If a trustee sells assets of the business or other activity, other than in the ordinary course of the business or activity, the trustee shall account for the net amount received as</p>
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<p>received as principal in the general accounting records of the trust to the extent the trustee determines that the amount received is no longer required in the conduct of the business.</p> <p>(C) Activities for which a trustee may maintain separate accounting records include:</p> <ol style="list-style-type: none"> (1) retail, manufacturing, service, and other traditional business activities; (2) farming; (3) raising and selling livestock and other animals; (4) management of rental properties; (5) extraction of minerals and other natural resources; (6) timber operations; and (7) activities subject to Section 62-7-923. 	<p>principal in the general accounting records of the trust to the extent the trustee determines that the amount received is no longer required in the conduct of the business.</p> <p>(C) Activities for which a trustee may maintain separate accounting records include:</p> <ol style="list-style-type: none"> (1) retail, manufacturing, service, and other traditional business activities; (2) farming; (3) raising and selling livestock and other animals; (4) management of rental properties; (5) extraction of minerals and other natural resources; (6) timber operations; and (7) activities subject to Section 62-7-923. <p>REPORTER’S COMMENT</p> <p>Purpose and scope. The provisions in Section 62-7-912 are intended to give greater flexibility to a trustee who operates a business or other activity in proprietorship form rather than in a wholly-owned corporation (or, where permitted by state law, a single-member limited liability company), and to facilitate the trustee’s ability to decide the extent to which the net receipts from the activity should be allocated to income, just as the board of directors of a corporation owned entirely by the trust would decide the amount of the annual dividend to be paid to the trust. It permits a trustee to account for farming or livestock operations, rental properties, oil and gas properties, timber operations, and activities in derivatives and options as though they were held by a separate entity. It is not intended, however, to permit a trustee to account separately for a traditional securities portfolio to avoid the provisions of this Act that apply to such securities.</p> <p>Section 62-7-912 permits the trustee to account separately for each business or activity for which the trustee determines separate accounting is appropriate. A trustee with a computerized accounting system may account for these activities in a “subtrust”; an individual</p>
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trustee may continue to use the business and record-keeping methods employed by the decedent or transferor who may have conducted the business under an assumed name. The intent of this section is to give the trustee broad authority to select business record-keeping methods that best suit the activity in which the trustee is engaged.

If a fiduciary liquidates a sole proprietorship or other activity to which Section 62-7-912 applies, the proceeds would be added to principal, even though derived from the liquidation of accounts receivable, because the proceeds would no longer be needed in the conduct of the business. If the liquidation occurs during probate or during an income interest's winding up period, none of the proceeds would be income for purposes of Section 62-7-905.

Separate accounts. A trustee may or may not maintain separate bank accounts for business activities that are accounted for under Section 62-7-912. A professional trustee may decide not to maintain separate bank accounts, but an individual trustee, especially one who has continued a decedent's business practices, may continue the same banking arrangements that were used during the decedent's lifetime. In either case, the trustee is authorized to decide to what extent cash is to be retained as part of the business assets and to what extent it is to be transferred to the trust's general accounts, either as income or principal.

SECTION 62-7-913. Allocations to principal.

A trustee shall allocate to principal:
(1) to the extent not allocated to income pursuant to this part, assets received from a transferor during his lifetime, a decedent's estate, a trust with a terminating income interest, or a payer under a contract naming the trust or its trustee as beneficiary;
(2) money or other property received from the

SECTION 62-7-913.

A trustee shall allocate to principal:
(1) to the extent not allocated to income pursuant to this part, assets received from a transferor during his lifetime, a decedent's estate, a trust with a terminating income interest, or a payer under a contract naming the trust or its trustee as beneficiary;
(2) money or other property received from

sale, exchange, liquidation, or change in form of a principal asset, including realized profit;

(3) amounts recovered from third parties to reimburse the trust because of disbursements described in Section 62-7-926(A)(7) or for other reasons to the extent not based on the loss of income;

(4) proceeds of property taken by eminent domain, but a separate award made for the loss of income with respect to an accounting period during which a current income beneficiary had a mandatory income interest is income;

(5) net income received in an accounting period during which there is no beneficiary to whom a trustee may or must distribute income; and

(6) other receipts as provided in Sections 62-7-917 through 62-7-924.

SECTION 62-7-914. Accounting for receipts from rental property.

To the extent that a trustee accounts for receipts from rental property pursuant to this section, the trustee shall allocate to income an amount received as rent of real or personal property, including an amount received for cancellation or renewal of a lease. An amount received as a refundable deposit, including a security deposit or a deposit applied as rent for future periods, must be added to principal and held subject to the terms of the lease and is not available for distribution to a beneficiary until the trustee's contractual obligations have been satisfied

the sale, exchange, liquidation, or change in form of a principal asset, including realized profit;

(3) amounts recovered from third parties to reimburse the trust because of disbursements described in Section 62-7-926(A)(7) or for other reasons to the extent not based on the loss of income;

(4) proceeds of property taken by eminent domain, but a separate award made for the loss of income with respect to an accounting period during which a current income beneficiary had a mandatory income interest is income;

(5) net income received in an accounting period during which there is no beneficiary to whom a trustee may or must distribute income; and

(6) other receipts as provided in Sections 62-7-917 through 62-7-924.

REPORTER'S COMMENT

Eminent domain awards. Even though the award in an eminent domain proceeding may include an amount for the loss of future rent on a lease, if that amount is not separately stated, the entire award is principal. The rule is the same in the 1931 and 1962 Acts and in the 1963 SC Act (Section 62-7-406(2)).

SECTION 62-7-914.

To the extent that a trustee accounts for receipts from rental property pursuant to this section, the trustee shall allocate to income an amount received as rent of real or personal property, including an amount received for cancellation or renewal of a lease. An amount received as a refundable deposit, including a security deposit or a deposit applied as rent for future periods, must be added to principal and held subject to the terms of the lease and is not available for distribution to a beneficiary until the trustee's contractual obligations have been satisfied with respect to that amount.

with respect to that amount.

REPORTER'S COMMENT

Application of Section 62-7-912. This section applies to the extent that the trustee does not account separately under Section 62-7-912 for the management of rental properties owned by the trust.

Receipts that are capital in nature. A portion of the payment under a lease may be a reimbursement of principal expenditures for improvements to the leased property that is characterized as rent for purposes of invoking contractual or statutory remedies for nonpayment. If the trustee is accounting for rental income under Section 62-7-914, a transfer from income to reimburse principal may be appropriate under Section 62-7-904 to the extent that some of the "rent" is really a reimbursement for improvements. This set of facts could also be a relevant factor for a trustee to consider under Section 62-7-904 (B) in deciding whether and to what extent to make an adjustment between principal and income under Section 62-7-904(A) after considering the return from the portfolio as a whole.

SECTION 62-7-915. Allocation of interest as income; allocation of proceeds from disposition of an obligation as principal; exceptions.

(A) An amount received as interest, whether determined at a fixed, variable, or floating rate, on an obligation to pay money to the trustee, including an amount received as consideration for prepaying principal, must be allocated to income without provision for amortization of premium.

(B) A trustee shall allocate to principal an amount received from the sale, redemption, or other disposition of an obligation to pay money to the trustee more than one year after it is purchased or acquired by the trustee, including an obligation whose purchase price

SECTION 62-7-915.

(A) An amount received as interest, whether determined at a fixed, variable, or floating rate, on an obligation to pay money to the trustee, including an amount received as consideration for prepaying principal, must be allocated to income without provision for amortization of premium.

(B) A trustee shall allocate to principal an amount received from the sale, redemption, or other disposition of an obligation to pay money to the trustee more than one year after it is purchased or acquired by the trustee, including an obligation whose purchase price or value

or value when it is acquired is less than its value at maturity. If the obligation matures within one year after it is purchased or acquired by the trustee, an amount received in excess of its purchase price or its value when acquired by the trust must be allocated to income.

(C) This section does not apply to an obligation subject to Section 62-7-918, 62-7-919, 62-7-920, 62-7-921, or 62-7-924.

when it is acquired is less than its value at maturity. If the obligation matures within one year after it is purchased or acquired by the trustee, an amount received in excess of its purchase price or its value when acquired by the trust must be allocated to income.

(C) This section does not apply to an obligation subject to Section 62-7-918, 62-7-919, 62-7-920, 62-7-921, or 62-7-924.

REPORTER'S COMMENT

Variable or floating interest rates. The reference in subsection (A) to variable or floating interest rate obligations is intended to clarify that, even though an obligation's interest rate may change from time to time based upon changes in an index or other market indicator, an obligation to pay money containing a variable or floating rate provision is subject to this section and is not to be treated as a derivative financial instrument under Section 62-7-923.

Discount obligations. Subsection (B) applies to all obligations acquired at a discount, including short-term obligations such as U.S. Treasury Bills, long-term obligations such as U.S. Savings Bonds, zero-coupon bonds, and discount bonds that pay interest during part, but not all, of the period before maturity. Under subsection (B) the entire increase in value of these obligations is principal when the trustee receives the proceeds from the disposition unless the obligation, when acquired, has a maturity of less than one year. In order to have one rule that applies to all discount obligations, this Act eliminates the provision in the 1962 Act for the payment from principal of an amount equal to the increase in the value of U.S. Series E bonds.

Subsection (B) also applies to inflation-indexed bonds - any increase in principal due to inflation after issuance is principal upon redemption if the bond matures more than one year after the trustee acquires it; if it matures within one year, all of the increase,

<p>SECTION 62-7-916. Allocation of proceeds of insurance contracts; exception.</p> <p>(A) Except as otherwise provided in subsection (B), a trustee shall allocate to principal the proceeds of a life insurance policy or other contract in which the trust or its trustee is named as beneficiary, including a contract that insures the trust or its trustee against loss for damage to, destruction of, or loss of title to a trust asset. The trustee shall allocate dividends on an insurance policy to income if the premiums on the policy are paid from income, and to principal if the premiums are paid from principal.</p> <p>(B) A trustee shall allocate to income proceeds of a contract that insures the trustee against loss of occupancy or other use by an income beneficiary, loss of income, or, subject to Section 62-7-912, loss of profits from a business.</p> <p>(C) This section does not apply to a contract subject to Section 62-7-918.</p> <p>SECTION 62-7-917. Insubstantial allocations.</p> <p>If a trustee determines that an allocation between principal and income required by Section 62-7-918, 62-7-919, 62-7-920, 62-7-921, or 62-7-924 is insubstantial, the trustee may allocate the entire amount to principal unless one of the circumstances</p>	<p>including any attributable to an inflation adjustment, is income.</p> <p>Effect of Section 62-7-904. In deciding whether and to what extent to exercise the power to adjust between principal and income granted by Section 62-7-904(A) a relevant factor for the trustee to consider is the effect on the portfolio as a whole of having a portion of the assets invested in bonds that do not pay interest currently.</p> <p>SECTION 62-7-916.</p> <p>(A) Except as otherwise provided in subsection (B), a trustee shall allocate to principal the proceeds of a life insurance policy or other contract in which the trust or its trustee is named as beneficiary, including a contract that insures the trust or its trustee against loss for damage to, destruction of, or loss of title to a trust asset. The trustee shall allocate dividends on an insurance policy to income if the premiums on the policy are paid from income, and to principal if the premiums are paid from principal.</p> <p>(B) A trustee shall allocate to income proceeds of a contract that insures the trustee against loss of occupancy or other use by an income beneficiary, loss of income, or, subject to Section 62-7-912, loss of profits from a business.</p> <p>(C) This section does not apply to a contract subject to Section 62-7-918.</p> <p>SECTION 62-7-917.</p> <p>If a trustee determines that an allocation between principal and income required by Section 62-7-918, 62-7-919, 62-7-920, 62-7-921, or 62-7-924 is insubstantial, the trustee may allocate the entire amount to principal unless one of the circumstances</p>
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provided in Section 62-7-904(C) applies to the allocation. This power may be exercised by a cotrustee in the circumstances provided in Section 62-7-904(D) and may be released for the reasons and in the manner provided in Section 62-7-904(E). An allocation is presumed to be insubstantial if:

(1) the amount of the allocation increases or decreases net income in an accounting period, as determined before the allocation, by less than ten percent; or

(2) the value of the asset producing the receipt for which the allocation is made is less than ten percent of the total value of the assets of the trust at the beginning of the accounting period.

provided in Section 62-7-904(C) applies to the allocation. This power may be exercised by a cotrustee in the circumstances provided in Section 62-7-904(D) and may be released for the reasons and in the manner provided in Section 62-7-904(E). An allocation is presumed to be insubstantial if:

(1) the amount of the allocation increases or decreases net income in an accounting period, as determined before the allocation, by less than ten percent; or

(2) the value of the asset producing the receipt for which the allocation is made is less than ten percent of the total value of the assets of the trust at the beginning of the accounting period.

REPORTER'S COMMENTS

This section is intended to relieve a trustee from making relatively small allocations while preserving the trustee's right to do so if an allocation is large in terms of absolute dollars.

For example, assume that a trust's assets, which include a working interest in an oil well, have a value of \$1,000,000; the net income from the assets other than the working interest is \$40,000; and the net receipts from the working interest are \$400. The trustee may allocate all of the net receipts from the working interest to principal instead of allocating ten percent or \$40, to income under Section 62-7-920. If the net receipts from the working interest are \$35,000, so that the amount allocated to income under Section 62-7-920 would be \$3,500, the trustee may decide that this amount is sufficiently significant to the income beneficiary that the allocation provided for by Section 62-7-920 should be made, even though the trustee is still permitted under Section 62-7-917 to allocate all of the net receipts to principal because the \$3,500 would increase the net income of \$40,000, as determined before making an allocation under Section 62-7-920 by less than ten percent. Section 62-7-917 will also relieve a trustee from having to allocate net

SECTION 62-7-918 HAS BEEN REPLACED BY ACT 204, S. 429, 2012

SECTION 62-7-918. Allocation of payments; interest, dividends, or payments made instead of interest or dividends; marital deductions; exception.

(A) In this section:

(1) 'Payment' means a payment that a trustee may receive over a fixed number of years or during the life of one or more individuals because of services rendered or property transferred to the payer in exchange for future payments. The term includes a payment made in money or property from the payer's general assets or from a separate fund created by the payer. For purposes of subsections (D), (E), (F), and (G), the term also includes a payment from a separate fund, regardless of the reason for the payment.

(2) 'Separate fund' includes a private or commercial annuity, an individual retirement account, and a pension, profit-sharing, stock-bonus, or stock-ownership plan.

(B) To the extent that a payment is characterized as interest, a dividend, or a payment made instead of interest or a dividend, a trustee shall allocate the payment to income. The trustee shall allocate to principal the balance of the payment and any other payment received in the same accounting period that is not characterized as interest, a dividend, or an equivalent payment.

(C) If part of a payment is not characterized as interest, a dividend, or an

receipts from the sale of trees in a small woodlot between principal and income.

While the allocation to principal of small amounts under this section should not be a cause for concern for tax purposes, allocations are not permitted under this section in circumstances described in Section 62-7-904 (C) to eliminate claims that the power in this section has adverse tax consequences.

ANY NEW VERSION OF THE TRUST CODE SHOULD INCLUDE THE NOW CURRENT LAW FOR SECTION 62-7-918 AS ENACTED BY ACT 204, S. 429, 2012, INCLUDED HEREIN

(A) In this section:

(1) 'Payment' means a payment that a trustee may receive over a fixed number of years or during the life of one or more individuals because of services rendered or property transferred to the payer in exchange for future payments. The term includes a payment made in money or property from the payer's general assets or from a separate fund created by the payer. For purposes of subsections (D), (E), (F), and (G), the term also includes a payment from a separate fund, regardless of the reason for the payment.

(2) 'Separate fund' includes a private or commercial annuity, an individual retirement account, and a pension, profit-sharing, stock-bonus, or stock-ownership plan.

(B) To the extent that a payment is characterized as interest, a dividend, or a payment made instead of interest or a dividend, a trustee shall allocate the payment to income. The trustee shall allocate to principal the balance of the payment and any other payment received in the same accounting period that is not characterized as interest, a dividend, or an equivalent payment.

(C) If part of a payment is not characterized as interest, a dividend, or an equivalent

equivalent payment, and all or part of the payment is required to be made, a trustee shall allocate to income ten percent of the part that is required to be made during the accounting period and the balance to principal. If a part of a payment is not required to be made or the payment received is the entire amount to which the trustee is entitled, the trustee shall allocate the entire payment to principal. For purposes of this subsection, a payment is not 'required to be made' to the extent that it is made because the trustee exercises a right of withdrawal.

(D) Except as otherwise provided in subsection (E), subsections (F) and (G) apply, and subsections (B) and (C) do not apply, in determining the allocation of a payment made from a separate fund to:

(1) a trust to which an election to qualify for a marital deduction under Section 2056(b)(7) of the Internal Revenue Code of 1986, as amended, has been made; or

(2) a trust that qualifies for the marital deduction under Section 2056(b)(5) of the Internal Revenue Code of 1986, as amended.

(E) Subsections (D), (F), and (G) do not apply if and to the extent that the series of payments would, without the application of subsection (D), qualify for the marital deduction under Section 2056(b)(7)(C) of the Internal Revenue Code of 1986, as amended.

(F) A trustee shall determine the internal income of each separate fund for the accounting period as if the separate fund were a trust subject to this act. Upon request of the surviving spouse, the trustee shall demand that the person administering the separate fund distribute the internal income to the trust. The trustee shall allocate a payment from the separate fund to income to the extent of the internal income of the separate fund and distribute that amount to the surviving spouse. The trustee shall allocate the balance of the payment to principal. Upon request of the surviving spouse, the trustee shall allocate principal to income to the extent the internal

payment, and all or part of the payment is required to be made, a trustee shall allocate to income ten percent of the part that is required to be made during the accounting period and the balance to principal. If a part of a payment is not required to be made or the payment received is the entire amount to which the trustee is entitled, the trustee shall allocate the entire payment to principal. For purposes of this subsection, a payment is not 'required to be made' to the extent that it is made because the trustee exercises a right of withdrawal.

(D) Except as otherwise provided in subsection (E), subsections (F) and (G) apply, and subsections (B) and (C) do not apply, in determining the allocation of a payment made from a separate fund to:

(1) a trust to which an election to qualify for a marital deduction under Section 2056(b)(7) of the Internal Revenue Code of 1986, as amended, has been made; or

(2) a trust that qualifies for the marital deduction under Section 2056(b)(5) of the Internal Revenue Code of 1986, as amended.

(E) Subsections (D), (F), and (G) do not apply if and to the extent that the series of payments would, without the application of subsection (D), qualify for the marital deduction under Section 2056(b)(7)(C) of the Internal Revenue Code of 1986, as amended.

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

income of the separate fund exceeds payments made from the separate fund to the trust during the accounting period.

(G) 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 is deemed to equal four percent of the fund's value, according to the most recent statement of value preceding the beginning of the accounting period. If the trustee can determine neither the internal income of the separate fund nor 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 Section 7520 of the Internal Revenue Code of 1986, as amended, for the month preceding the accounting period for which the computation is made.

(H) This section does not apply to payments subject to Section 62-7-919."

REPORTER'S COMMENTS

Scope. Section 62-7-918 applies to amounts received under contractual arrangements that provide for payments to a third party beneficiary as a result of services rendered or property transferred to the payer. While the right to receive such payments is a liquidating asset of the kind described in Section 62-7-919 i.e., "an asset whose value will diminish or terminate because the asset is expected to produce receipts for a period of limited duration," these payment rights are covered separately in Section 62-7-918 because of their special characteristics.

Section 62-7-918 applies to receipts from all forms of annuities and deferred compensation arrangements, whether the payment will be received by the trust in a lump sum or in installments over a period of years. It applies to bonuses that may be received over two or three years and payments that may last for much longer

made from the separate fund to the trust during the accounting period.

(G) 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 is deemed to equal four percent of the fund's value, according to the most recent statement of value preceding the beginning of the accounting period. If the trustee can determine neither the internal income of the separate fund nor 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 Section 7520 of the Internal Revenue Code of 1986, as amended, for the month preceding the accounting period for which the computation is made.

(H) This section does not apply to payments subject to Section 62-7-919."

REPORTER'S COMMENTS

Scope. Section 62-7-918 applies to amounts received under contractual arrangements that provide for payments to a third party beneficiary as a result of services rendered or property transferred to the payer. While the right to receive such payments is a liquidating asset of the kind described in Section 62-7-919 i.e., "an asset whose value will diminish or terminate because the asset is expected to produce receipts for a period of limited duration," these payment rights are covered separately in Section 62-7-918 because of their special characteristics.

Section 62-7-918 applies to receipts from all forms of annuities and deferred compensation arrangements, whether the payment will be received by the trust in a lump sum or in installments over a period of years. It applies to bonuses that may be received over two or three years and payments that may last for much longer periods, including payments from an individual retirement account (IRA), deferred compensation plan (whether qualified or not qualified for special federal income tax treatment), and insurance renewal commissions.

periods, including payments from an individual retirement account (IRA), deferred compensation plan (whether qualified or not qualified for special federal income tax treatment), and insurance renewal commissions. It applies to a retirement plan to which the settlor has made contributions, just as it applies to an annuity policy that the settlor may have purchased individually, and it applies to variable annuities, deferred annuities, annuities issued by commercial insurance companies, and “private annuities” arising from the sale of property to another individual or entity in exchange for payments that are to be made for the life of one or more individuals. The section applies whether the payments begin when the payment right becomes subject to the trust or are deferred until a future date, and it applies whether payments are made in cash or in kind, such as employer stock (in-kind payments usually will be made in a single distribution that will be allocated to principal under the second sentence of subsection (C)).

Prior Acts. Under Section 12 of the 1962 Act and Section 62-7-414 of the 1963 SC Act, receipts from “rights to receive payments on a contract for deferred compensation” are allocated to income each year in an amount “not in excess of 5% per year” of the property’s inventory value. While “not in excess of 5%” suggests that the annual allocation may range from zero to five percent of the inventory value, in practice the rule is usually treated as prescribing a five percent allocation. The inventory value is usually the present value of all the future payments, and since the inventory value is determined as of the date on which the payment right becomes subject to the trust, the inventory value, and thus the amount of the annual income allocation, depends significantly on the applicable interest rate on the decedent’s date of death. That rate may be much higher or lower than the average long-term interest rate. The amount

It applies to a retirement plan to which the settlor has made contributions, just as it applies to an annuity policy that the settlor may have purchased individually, and it applies to variable annuities, deferred annuities, annuities issued by commercial insurance companies, and “private annuities” arising from the sale of property to another individual or entity in exchange for payments that are to be made for the life of one or more individuals. The section applies whether the payments begin when the payment right becomes subject to the trust or are deferred until a future date, and it applies whether payments are made in cash or in kind, such as employer stock (in-kind payments usually will be made in a single distribution that will be allocated to principal under the second sentence of subsection (C)).

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Allocations Under Section 62-7-918(B). Section 62-7-918(B) applies to plans whose terms characterize payments made under the plan as dividends, interest, or payments in lieu

determined under the five percent formula tends to become fixed and remain unchanged even though the amount received by the trust increases or decreases.

Allocations Under Section 62-7-918(B). Section 62-7-918(B) applies to plans whose terms characterize payments made under the plan as dividends, interest, or payments in lieu of dividends or interest. For example, some deferred compensation plans that hold debt obligations or stock of the plan's sponsor in an account for future delivery to the person rendering the services provide for the annual payment to that person of dividends received on the stock or interest received on the debt obligations. Other plans provide that the account of the person rendering the services shall be credited with "phantom" shares of stock and require an annual payment that is equivalent to the dividends that would be received on that number of shares if they were actually issued; or a plan may entitle the person rendering the services to receive a fixed dollar amount in the future and provide for the annual payment of interest on the deferred amount during the period prior to its payment. Under Section 62-7-918(B) payments of dividends, interest or payments in lieu of dividends or interest under plans of this type are allocated to income; all other payments received under these plans are allocated to principal.

Section 62-7-918(B) does not apply to an IRA or an arrangement with payment provisions similar to an IRA. IRAs and similar arrangements are subject to the provisions in Section 62-7-918(C).

Allocations Under Section 62-7-918(C). The focus of Section 62-7-918, for purposes of allocating payments received by a trust to or between principal and income, is on the payment right rather than on assets that may be held in a fund from which the payments are made. Thus, if an IRA holds a portfolio of marketable stocks and bonds, the amount received by the IRA as dividends and interest

of dividends or interest. For example, some deferred compensation plans that hold debt obligations or stock of the plan's sponsor in an account for future delivery to the person rendering the services provide for the annual payment to that person of dividends received on the stock or interest received on the debt obligations. Other plans provide that the account of the person rendering the services shall be credited with "phantom" shares of stock and require an annual payment that is equivalent to the dividends that would be received on that number of shares if they were actually issued; or a plan may entitle the person rendering the services to receive a fixed dollar amount in the future and provide for the annual payment of interest on the deferred amount during the period prior to its payment. Under Section 62-7-918(B) payments of dividends, interest or payments in lieu of dividends or interest under plans of this type are allocated to income; all other payments received under these plans are allocated to principal.

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Allocations Under Section 62-7-918(C). The focus of Section 62-7-918, for purposes of allocating payments received by a trust to or between principal and income, is on the payment right rather than on assets that may be held in a fund from which the payments are made. Thus, if an IRA holds a portfolio of marketable stocks and bonds, the amount received by the IRA as dividends and interest is not taken into account in determining the principal and income allocation except to the extent that the Internal Revenue Service may require them to be taken into account when the payment is received by a trust that qualifies for the estate tax marital deduction (a situation that is provided for in Section 62-7-918(D)). An IRA is subject to federal income tax rules that require payments to begin by a particular date

is not taken into account in determining the principal and income allocation except to the extent that the Internal Revenue Service may require them to be taken into account when the payment is received by a trust that qualifies for the estate tax marital deduction (a situation that is provided for in Section 62-7-918(D)). An IRA is subject to federal income tax rules that require payments to begin by a particular date and be made over a specific number of years or a period measured by the lives of one or more persons. The payment right of a trust that is named as a beneficiary of an IRA is not a right to receive particular items that are paid to the IRA, but is instead the right to receive an amount determined by dividing the value of the IRA by the remaining number of years in the payment period. This payment right is similar to the right to receive a unitrust amount, which is normally expressed as an amount equal to a percentage of the value of the unitrust assets without regard to dividends or interest that may be received by the unitrust.

An amount received from an IRA or a plan with a payment provision similar to that of an IRA is allocated under Section 62-7-918(C) which differentiates between payments that are required to be made and all other payments. To the extent that a payment is required to be made (either under federal income tax rules or, in the case of a plan that is not subject to those rules, under the terms of the plan), ten percent of the amount received is allocated to income and the balance is allocated to principal. All other payments are allocated to principal because they represent a change in the form of a principal asset; Section 62-7-918 follows the rule in Section 62-7-913(2) which provides that money or property received from a change in the form of a principal asset be allocated to principal.

Section 62-7-918(C) produces an allocation to income that is similar to the allocation under the 1962 Act formula and the 1963 SC

and be made over a specific number of years or a period measured by the lives of one or more persons. The payment right of a trust that is named as a beneficiary of an IRA is not a right to receive particular items that are paid to the IRA, but is instead the right to receive an amount determined by dividing the value of the IRA by the remaining number of years in the payment period. This payment right is similar to the right to receive a unitrust amount, which is normally expressed as an amount equal to a percentage of the value of the unitrust assets without regard to dividends or interest that may be received by the unitrust.

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Section 62-7-918(C) produces an allocation to income that is similar to the allocation under the 1962 Act formula and the 1963 SC Act formula if the annual payments are the same throughout the payment period, and it is simpler to administer. The amount allocated to income under Section 62-7-918 is not dependent upon the interest rate that is used for valuation purposes when the decedent dies, and if the payments received by the trust increase or decrease from year to year because the fund from which the payment is made increases or decreases in value, the amount allocated to income will also increase or decrease.

Marital Deduction Requirements. When an

Act formula if the annual payments are the same throughout the payment period, and it is simpler to administer. The amount allocated to income under Section 62-7-918 is not dependent upon the interest rate that is used for valuation purposes when the decedent dies, and if the payments received by the trust increase or decrease from year to year because the fund from which the payment is made increases or decreases in value, the amount allocated to income will also increase or decrease.

Marital Deduction Requirements. When an IRA or other retirement arrangement (a “plan”) is payable to a marital deduction trust, the IRS treats the plan as a separate property interest that itself must qualify for the marital deduction. IRS Revenue Ruling 2006-26 said that, as written, the prior uniform act version of Section 62-7-918 does not cause a trust to qualify for the IRS’ safe harbors. Revenue Ruling 2006-26 was limited in scope to certain situations involving IRAs and defined contribution retirement plans. Without necessarily agreeing with the IRS’ position in that ruling, the revision to this section is designed to satisfy the IRS’ safe harbor and to address concerns that might be raised for similar assets. No IRS pronouncements have addressed the scope of Code § 2056(b)(7)(C).

Subsection (F) requires the trustee to demand certain distributions if the surviving spouse so requests. The safe harbor of Revenue Ruling 2006-26 requires that the surviving spouse be separately entitled to demand the fund’s income (without regard to the income from the trust’s other assets) and the income from the other assets (without regard to the fund’s income). In any event, the surviving spouse is not required to demand that the trustee distribute all of the fund’s income from the fund or from other trust assets. Treas. Reg. § 20.2056(b)-5(f)(8).

Subsection (F) also recognizes that the trustee might not control the payments that the trustee receives and provides a remedy to

IRA or other retirement arrangement (a “plan”) is payable to a marital deduction trust, the IRS treats the plan as a separate property interest that itself must qualify for the marital deduction. IRS Revenue Ruling 2006-26 said that, as written, the prior uniform act version of Section 62-7-918 does not cause a trust to qualify for the IRS’ safe harbors. Revenue Ruling 2006-26 was limited in scope to certain situations involving IRAs and defined contribution retirement plans. Without necessarily agreeing with the IRS’ position in that ruling, the revision to this section is designed to satisfy the IRS’ safe harbor and to address concerns that might be raised for similar assets. No IRS pronouncements have addressed the scope of Code § 2056(b)(7)(C).

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Subsection (F) also recognizes that the trustee might not control the payments that the trustee receives and provides a remedy to the surviving spouse if the distributions under subsection (d)(1) are insufficient.

Subsection (G) addresses situations where, due to lack of information provided by the fund’s administrator, the trustee is unable to determine the fund’s actual income. The bracketed language is the range approved for unitrust payments by Treas. Reg. § 1.643(b)-1. In determining the value for purposes of applying the unitrust percentage, the trustee would seek to obtain the value of the assets as of the most recent statement of value immediately preceding the beginning of the year. For example, suppose a trust’s accounting period is

the surviving spouse if the distributions under subsection (d)(1) are insufficient.

Subsection (G) addresses situations where, due to lack of information provided by the fund's administrator, the trustee is unable to determine the fund's actual income. The bracketed language is the range approved for unitrust payments by Treas. Reg. § 1.643(b)-1. In determining the value for purposes of applying the unitrust percentage, the trustee would seek to obtain the value of the assets as of the most recent statement of value immediately preceding the beginning of the year. For example, suppose a trust's accounting period is January 1 through December 31. If a retirement plan administrator furnishes information annually each September 30 and declines to provide information as of December 31, then the trustee may rely on the September 30 value to determine the distribution for the following year. For funds whose values are not readily available, subsection (G) relies on Code Section 7520 valuation methods because many funds described in Section 62-7-918 are annuities, and one consistent set of valuation principles should apply whether or not the fund is, in fact, an annuity.

Application of Section 62-7-904. Section 62-7-904(A) of this act gives a trustee who is acting under the prudent investor rule the power to adjust from principal to income if, considering the portfolio as a whole and not just receipts from deferred compensation, the trustee determines that an adjustment is necessary. See Example (5) in the comment following Section 62-7-904.

SECTION 62-7-919. Liquidating assets.

(A) In this section, "liquidating asset" means an asset whose value diminishes or terminates because the asset is expected to produce receipts for a period of limited duration. The

January 1 through December 31. If a retirement plan administrator furnishes information annually each September 30 and declines to provide information as of December 31, then the trustee may rely on the September 30 value to determine the distribution for the following year. For funds whose values are not readily available, subsection (G) relies on Code Section 7520 valuation methods because many funds described in Section 62-7-918 are annuities, and one consistent set of valuation principles should apply whether or not the fund is, in fact, an annuity.

Application of Section 62-7-904. Section 62-7-904(A) of this act gives a trustee who is acting under the prudent investor rule the power to adjust from principal to income if, considering the portfolio as a whole and not just receipts from deferred compensation, the trustee determines that an adjustment is necessary. See Example (5) in the comment following Section 62-7-904.

SECTION 62-7-919.

(A) In this section, 'liquidating asset' means an asset whose value diminishes or terminates because the asset is expected to produce receipts for a period of limited duration. The term

<p>term includes a leasehold, patent, copyright, royalty right, and right to receive payments during a period of more than one year under an arrangement that does not provide for the payment of interest on the unpaid balance. The term does not include a payment subject to Section 62-7-918, resources subject to Section 62-7-920, timber subject to Section 62-7-921, an activity subject to Section 62-7-923, an asset subject to Section 62-7-924, or any asset for which the trustee establishes a reserve for depreciation pursuant to Section 62-7-927.</p> <p>(B) A trustee shall allocate to income ten percent of the receipts from a liquidating asset and the balance to principal.</p>	<p>includes a leasehold, patent, copyright, royalty right, and right to receive payments during a period of more than one year under an arrangement that does not provide for the payment of interest on the unpaid balance. The term does not include a payment subject to Section 62-7-918, resources subject to Section 62-7-920, timber subject to Section 62-7-921, an activity subject to Section 62-7-923, an asset subject to Section 62-7-924, or any asset for which the trustee establishes a reserve for depreciation pursuant to Section 62-7-927.</p> <p>(B) A trustee shall allocate to income ten percent of the receipts from a liquidating asset and the balance to principal.</p> <p>REPORTER’S COMMENT</p> <p>Prior Acts. Section 11 of the 1962 Act (Section 62-7-414 of the 1963 SC Act) allocates receipts from “property subject to depletion” to income in an amount “not in excess of 5%” of the asset’s inventory value. The 1931 Act has a similar five percent rule that applies when the trustee is under a duty to change the form of the investment. The five percent rule imposes on a trust the obligation to pay a fixed annuity to the income beneficiary until the asset is exhausted. Under these prior Acts the balance of each year’s receipts is added to principal. A fixed payment can produce unfair results. The remainder beneficiary receives all of the receipts from unexpected growth in the asset, e.g., if royalties on a patent or copyright increase significantly. Conversely, if the receipts diminish more rapidly than expected, most of the amount received by the trust will be allocated to income and little to principal. Moreover, if the annual payments remain the same for the life of the asset, the amount allocated to principal will usually be less than the original inventory value. For these reasons, Section 62-7-919 abandons the annuity approach under the five percent rule.</p> <p>Lottery payments. The reference in subsection (A) to rights to receive payments</p>
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SECTION 62-7-920. Allocation of receipts from interests in minerals or other natural resources.

(A) To the extent that a trustee accounts for receipts from an interest in minerals or other natural resources pursuant to this section, the trustee shall allocate them if:

(1) received as nominal delay rental or nominal annual rent on a lease, a receipt must be allocated to income;

(2) received from a production payment, a receipt must be allocated to income if and to the extent that the agreement creating the production payment provides a factor for interest or its equivalent. The balance must be allocated to principal;

(3) an amount received as a royalty, shut-in-well payment, take-or-pay payment, bonus, or delay rental is more than nominal, ninety percent must be allocated to principal and the balance to income;

(4) an amount is received from a working interest or any other interest not otherwise provided for in this subsection, ninety percent of the net amount received must be allocated to principal and the balance to income.

(B) An amount received on account of an interest in water that is renewable must be allocated to income. If the water is not renewable, ninety percent of the amount must be allocated to principal and the balance to income.

(C) This part applies whether or not a decedent or donor was extracting minerals, water, or other natural resources before the interest became subject to the trust.

(D) If a trust owns an interest in minerals, water, or other natural resources on the

under an arrangement that does not provide for the payment of interest includes state lottery prizes and similar fixed amounts payable over time that are not deferred compensation arrangements covered by Section 62-7-918.

SECTION 62-7-920.

(A) To the extent that a trustee accounts for receipts from an interest in minerals or other natural resources pursuant to this section, the trustee shall allocate them if:

(1) received as nominal delay rental or nominal annual rent on a lease, a receipt must be allocated to income;

(2) received from a production payment, a receipt must be allocated to income if and to the extent that the agreement creating the production payment provides a factor for interest or its equivalent. The balance must be allocated to principal;

(3) an amount received as a royalty, shut-in-well payment, take-or-pay payment, bonus, or delay rental is more than nominal, ninety percent must be allocated to principal and the balance to income;

(4) an amount is received from a working interest or any other interest not otherwise provided for in this subsection, ninety percent of the net amount received must be allocated to principal and the balance to income.

(B) An amount received on account of an interest in water that is renewable must be allocated to income. If the water is not renewable, ninety percent of the amount must be allocated to principal and the balance to income.

(C) This part applies whether or not a decedent or donor was extracting minerals, water, or other natural resources before the interest became subject to the trust.

(D) If a trust owns an interest in minerals, water, or other natural resources on the effective date of this part, the trustee may allocate

effective date of this part, the trustee may allocate receipts from the interest as provided in this part or in the manner used by the trustee before the effective date of this part. If the trust acquires an interest in minerals, water, or other natural resources after the effective date of this part, the trustee shall allocate receipts from the interest as provided in this part.

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REPORTER'S COMMENT

Prior Acts. The 1962 Act and the 1963 SC Act allocate to principal as a depletion allowance, twenty seven and one-half percent of the gross receipts, but not more than fifty percent of the net receipts after paying expenses. Section 9 of the 1931 Act allocates all of the net proceeds received as consideration for the "permanent severance of natural resources from the lands" to principal.

Section 62-7-920 allocates ninety percent of the net receipts to principal and ten percent to income. A depletion provision that is tied to past or present Code provisions is undesirable because it causes a large portion of the oil and gas receipts to be paid out as income. As wells are depleted, the amount received by the income beneficiary falls drastically. Allocating a larger portion of the receipts to principal enables the trustee to acquire other income producing assets that will continue to produce income when the mineral reserves are exhausted.

Application of Sections 62-7-912 and 917. This Section 62-7-920 applies to the extent that the trustee does not account separately for receipts from minerals and other natural resources under Section 62-7-912 or allocate all of the receipts to principal under Section 62-7-917.

Open mine doctrine. The purpose of Section 62-7-920(C) is to abolish the "open mine doctrine" as it may apply to the rights of an income beneficiary and a remainder beneficiary in receipts from the production of minerals from land owned or leased by a trust. Instead, such receipts are to be allocated to or between principal and income in accordance with the

provisions of this Act. For a discussion of the open mine doctrine, see generally 3A Austin W. Scott & William F. Fratcher, *The Law of Trusts* §239.3 (4th ed. 1988), and *Nutter v. Stockton*, 626 P.2d 861 (Okla. 1981).

Effective date provision. Section 9(b) of the 1962 Act and Section 4122(b) of the SC Act provide that the natural resources provision does not apply to property interests held by the trust on the effective date of the Act, which reflects concerns about the constitutionality of applying a retroactive administrative provision to interests in real estate, based on the opinion in the Oklahoma case of *Franklin v. Margay Oil Corporation*, 153 P.2d 486, 501 (Okla. 1944). Section 62-7-920(D) permits a trustee to use either the method provided for in this Act or the method used before the Act takes effect. Lawyers in jurisdictions other than Oklahoma may conclude that retroactivity is not a problem as to property situated in their States, and this provision permits trustees to decide, based on advice from counsel in States whose law may be different from that of Oklahoma, whether they may apply this provision retroactively if they conclude that to do so is in the best interests of the beneficiaries.

If the property is in a State other than the State where the trust is administered, the trustee must be aware that the law of the property's situs may control this question. The outcome turns on a variety of questions: whether the terms of the trust specify that the law of a State other than the situs of the property shall govern the administration of the trust, and whether the courts will follow the terms of the trust; whether the trust's asset is the land itself or a leasehold interest in the land (as it frequently is with oil and gas property); whether a leasehold interest or its proceeds should be classified as real property or personal property, and if as personal property, whether applicable state law treats it as a movable or an immovable for conflict of laws purposes. See 5A Austin W. Scott & William F. Fratcher, *The Law of Trusts* Sections 648, at 531, 533-534; Sec 657, at 600 (4th ed.

<p>SECTION 62-7-921. Allocation of receipts from sale of timber and related products.</p> <p>(A) To the extent that a trustee accounts for receipts from the sale of timber and related products pursuant to this section, the trustee shall allocate the net receipts to:</p> <p>(1) income, to the extent that the amount of timber removed from the land does not exceed the rate of growth of the timber during the accounting periods in which a beneficiary has a mandatory income interest;</p> <p>(2) principal, to the extent that the amount of timber removed from the land exceeds the rate of growth of the timber or the net receipts are from the sale of standing timber;</p> <p>(3) or between income and principal, if the net receipts are from the lease of timberland or from a contract to cut timber from land owned by a trust, by determining the amount of timber removed from the land under the lease or contract and applying items (1) and (2); or</p> <p>(4) principal, to the extent that advance payments, bonuses, and other payments are not otherwise allocated pursuant to this subsection.</p> <p>(B) In determining net receipts to be allocated pursuant to subsection (A), a trustee shall deduct and transfer to principal a reasonable amount for depletion.</p> <p>(C) This part applies whether or not a decedent or transferor was harvesting timber from the property before it became subject to the trust.</p> <p>(D) If a trust owns an interest in timberland on the effective date of this part, the trustee may allocate net receipts from the sale of timber and related products as provided in this part or in the manner used by the trustee before the effective date of this part. If the trust acquires an interest in timberland after the effective date of this part, the trustee shall</p>	<p>1989).</p> <p>SECTION 62-7-921.</p> <p>(A) To the extent that a trustee accounts for receipts from the sale of timber and related products pursuant to this section, the trustee shall allocate the net receipts to:</p> <p>(1) income, to the extent that the amount of timber removed from the land does not exceed the rate of growth of the timber during the accounting periods in which a beneficiary has a mandatory income interest;</p> <p>(2) principal, to the extent that the amount of timber removed from the land exceeds the rate of growth of the timber or the net receipts are from the sale of standing timber;</p> <p>(3) or between income and principal, if the net receipts are from the lease of timberland or from a contract to cut timber from land owned by a trust, by determining the amount of timber removed from the land under the lease or contract and applying items (1) and (2); or</p> <p>(4) principal, to the extent that advance payments, bonuses, and other payments are not otherwise allocated pursuant to this subsection.</p> <p>(B) In determining net receipts to be allocated pursuant to subsection (A), a trustee shall deduct and transfer to principal a reasonable amount for depletion.</p> <p>(C) This part applies whether or not a decedent or transferor was harvesting timber from the property before it became subject to the trust.</p> <p>(D) If a trust owns an interest in timberland on the effective date of this part, the trustee may allocate net receipts from the sale of timber and related products as provided in this part or in the manner used by the trustee before the effective date of this part. If the trust acquires an interest in timberland after the effective date of this part, the trustee shall allocate net receipts from the sale of timber and related products as provided in this part.</p>
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allocate net receipts from the sale of timber and related products as provided in this part.

REPORTER'S COMMENT

Scope of section. The rules in Section 62-7-921 are intended to apply to net receipts from the sale of trees and by-products from harvesting and processing trees without regard to the kind of trees that are cut or whether the trees are cut before or after a particular number of years of growth. The rules apply to the sale of trees that are expected to produce lumber for building purposes, trees sold as pulpwood, and Christmas and other ornamental trees. Subsection (A) applies to net receipts from property owned by the trustee and property leased by the trustee. The Act is not intended to prevent a tenant in possession of the property from using wood that he cuts on the property for personal, noncommercial purposes, such as a Christmas tree, firewood, mending old fences or building new fences, or making repairs to structures on the property.

Under subsection (A) the amount of net receipts allocated to income depends upon whether the amount of timber removed is more or less than the rate of growth. The method of determining the amount of timber removed and the rate of growth is up to the trustee, based on methods customarily used for the kind of timber involved.

Application of Sections 62-7-912 and 917. This Section 62-7-921 applies to the extent that the trustee does not account separately for net receipts from the sale of timber and related products under Section 62-7-912 or allocate all of the receipts to principal under Section 62-7-917. The option to account for net receipts separately under Section 62-7-912 takes into consideration the possibility that timber harvesting operations may have been conducted before the timber property became subject to the trust, and that it may make sense to continue using accounting methods previously established for the property. It also permits a trustee to use customary accounting practices for timber operations even if no harvesting

<p>SECTION 62-7-922. Marital deduction adjustments.</p> <p>(A) If a marital deduction is allowed for all or part of a trust whose assets consist substantially of property that does not provide the surviving spouse with sufficient income from or use of the trust assets, and if the amounts that the trustee transfers from principal to income pursuant to Section 62-7-904 and distributes to the spouse from principal pursuant to the terms of the trust are insufficient to provide the spouse with the beneficial enjoyment required to obtain the marital deduction, the spouse may require the trustee to make property productive of income, convert property within a reasonable time, or exercise the power in Section 62-7-904(A). The trustee may decide which action or combination of actions to take.</p> <p>(B) If subsection (A) is inapplicable, proceeds from the sale or other disposition of an asset are principal without regard to the amount of income the asset produces during any accounting period.</p>	<p>occurred on the property before it became subject to the trust.</p> <p>SECTION 62-7-922.</p> <p>(A) If a marital deduction is allowed for all or part of a trust whose assets consist substantially of property that does not provide the surviving spouse with sufficient income from or use of the trust assets, and if the amounts that the trustee transfers from principal to income pursuant to Section 62-7-904 and distributes to the spouse from principal pursuant to the terms of the trust are insufficient to provide the spouse with the beneficial enjoyment required to obtain the marital deduction, the spouse may require the trustee to make property productive of income, convert property within a reasonable time, or exercise the power in Section 62-7-904(A). The trustee may decide which action or combination of actions to take.</p> <p>(B) If subsection (A) is inapplicable, proceeds from the sale or other disposition of an asset are principal without regard to the amount of income the asset produces during any accounting period.</p> <p>REPORTER’S COMMENT</p> <p>Prior Acts’ Conflict with the South Carolina Uniform Prudent Investor Act. Section 62-7-933(C)(2) of SCUPIA provides that “[a] trustee’s investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole” The underproductive property provisions in Section 12 of the 1962 Act, Section 62-7-415 of the 1963 SC Act, and Section 11 of the 1931 Act give the income beneficiary a right to receive a portion of the proceeds from the sale of underproductive property as “delayed income.” In each Act the provision applies on an asset by asset basis and not by taking into consideration the trust portfolio as a whole, which conflicts with the</p>
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basic precept in Section 62-7-933(C)(2) of SCUPIA. Moreover, in determining the amount of delayed income, the prior Acts do not permit a trustee to take into account the extent to which the trustee may have distributed principal to the income beneficiary, under principal invasion provisions in the terms of the trust, to compensate for insufficient income from the unproductive asset. Under Section 62-7-904(B)(7) of this Act, a trustee must consider prior distributions of principal to the income beneficiary in deciding whether and to what extent to exercise the power to adjust conferred by Section 62-7-904(A).

Duty to make property productive of income. In order to implement SCUPIA, this Act abolishes the right to receive delayed income from the sale proceeds of an asset that produces little or no income, but it does not alter existing state law regarding the income beneficiary's right to compel the trustee to make property productive of income. As the law continues to develop in this area, the duty to make property productive of current income in a particular situation should be determined by taking into consideration the performance of the portfolio as a whole and the extent to which a trustee makes principal distributions to the income beneficiary under the terms of the trust and adjustments between principal and income under Section 62-7-904 of this Act.

Trusts for which the value of the right to receive income is important for tax reasons may be affected by Reg. Sec 1.7520-3(b)(2)(v) *Example (1)*, Sec 20.7520-3(b)(2)(v) *Examples (1) and (2)*, and Sec 25.7520-3(b)(2)(v) *Examples (1) and (2)*, which provide that if the income beneficiary does not have the right to compel the trustee to make the property productive, the income interest is considered unproductive and may not be valued actuarially under those sections.

Marital deduction trusts. Subsection (A) draws on language in Reg. Sec 20.2056(b)-5(f)(4) and (5) to enable a trust for a spouse to qualify for a marital deduction if

applicable state law is unclear about the spouse's right to compel the trustee to make property productive of income. The trustee should also consider the application of Section 62-7-904 of this Act and the provisions of Restatement of Trusts 3d: Prudent Investor Rule Sec 240, at 186, app. Sec 240, at 252 (1992). Example (6) in the Comment to Section 62-7-904 describes a situation involving the payment from income of carrying charges on unproductive real estate in which Section 62-7-904 may apply.

Once the two conditions have occurred - insufficient beneficial enjoyment from the property and the spouse's demand that the trustee take action under this section - the trustee must act; but instead of the formulaic approach of both the 1962 and the 1963 SC Acts which is triggered only if the trustee sells the property, this Act permits the trustee to decide whether to make the property productive of income, convert it, transfer funds from principal to income, or to take some combination of those actions. The trustee may rely on the power conferred by Section 62-7-904(A) to adjust from principal to income if the trustee decides that it is not feasible or appropriate to make the property productive of income or to convert the property. Given the purpose of Section 62-7-922 the power under Section 62-7-904(A) would be exercised to transfer principal to income and not to transfer income to principal.

Section 62-7-922 does not apply to a so-called "estate" trust, which will qualify for the marital deduction, even though the income may be accumulated for a term of years or for the life of the surviving spouse, if the terms of the trust require the principal and undistributed income to be paid to the surviving spouse's estate when the spouse dies. Reg. Sec 20.2056(c)-2(b)(1)(iii).

SECTION 62-7-923. Allocation of derivatives; options.

(A) In this section, “derivative” means a contract or financial instrument or a combination of contracts and financial instruments which gives a trust the right or obligation to participate in some or all changes in the price of a tangible or intangible asset or group of assets, or changes in a rate, an index of prices or rates, or other market indicator for an asset or a group of assets.

(B) To the extent that a trustee does not account pursuant to Section 62-7-912 for transactions in derivatives, the trustee shall allocate to principal receipts from and disbursements made in connection with those transactions.

(C) If a trustee grants an option to buy property from the trust, whether or not the trust owns the property when the option is granted, grants an option that permits another person to sell property to the trust, or acquires an option to buy property for the trust or an option to sell an asset owned by the trust, and the trustee or other owner of the asset is required to deliver the asset if the option is exercised, an amount received for granting the option must be allocated to principal. An amount paid to acquire the option must be paid from principal. A gain or loss realized upon the exercise of an option, including an option granted to a settlor of the trust for services rendered, must be allocated to principal.

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(B) To the extent that a trustee does not account pursuant to Section 62-7-912 for transactions in derivatives, the trustee shall allocate to principal receipts from and disbursements made in connection with those transactions.

(C) If a trustee grants an option to buy property from the trust, whether or not the trust owns the property when the option is granted, grants an option that permits another person to sell property to the trust, or acquires an option to buy property for the trust or an option to sell an asset owned by the trust, and the trustee or other owner of the asset is required to deliver the asset if the option is exercised, an amount received for granting the option must be allocated to principal. An amount paid to acquire the option must be paid from principal. A gain or loss realized upon the exercise of an option, including an option granted to a settlor of the trust for services rendered, must be allocated to principal.

REPORTER’S COMMENT

Scope and application. It is difficult to predict how frequently and to what extent trustees will invest directly in derivative financial instruments rather than participating indirectly through investment entities that may utilize these instruments in varying degrees. If the trust participates in derivatives indirectly through an entity, an amount received from the entity will be allocated under Section 62-7-910 and not

Section 62-7-923. If a trustee invests directly in derivatives to a significant extent, the expectation is that receipts and disbursements related to derivatives will be accounted for under Section 62-7-912; if a trustee chooses not to account under Section 62-7-912. Section 62-7-923(B) provides the default rule. Certain types of option transactions in which trustees may engage are dealt with in subsection (C) to distinguish those transactions from ones involving options that are embedded in derivative financial instruments.

Definition of “derivative.” “Derivative” is a difficult term to define because new derivatives are invented daily as dealers tailor their terms to achieve specific financial objectives for particular clients. Since derivatives are typically contract-based, a derivative can probably be devised for almost any set of objectives if another party can be found who is willing to assume the obligations required to meet those objectives.

The most comprehensive definition of derivative is in the Exposure Draft of a Proposed Statement of Financial Accounting Standards titled “Accounting for Derivative and Similar Financial Instruments and for Hedging Activities,” which was released by the Financial Accounting Standards Board (FASB) on June 20, 1996 (No. 162-B). The definition in Section 62-7-923(A) is derived in part from the FASB definition. The purpose of the definition in subsection (A) is to implement the substantive rule in subsection (B) that provides for all receipts and disbursements to be allocated to principal to the extent the trustee elects not to account for transactions in derivatives under Section 62-7-912. As a result, it is much shorter than the FASB definition, which serves much more ambitious objectives.

A derivative is frequently described as including futures, forwards, swaps and options, terms that also require definition, and the definition in this Act avoids these terms. FASB used the same approach, explaining in paragraph 65 of the Exposure Draft:

The definition of *derivative financial instrument* in this Statement includes those financial instruments generally considered to be derivatives, such as forwards, futures, swaps, options, and similar instruments. The Board considered defining a derivative financial instrument by merely referencing those commonly understood instruments, similar to paragraph 5 of Statement 119, which says that "... a derivative financial instrument is a futures, forward, swap, or option contract, or other financial instrument with similar characteristics." However, the continued development of financial markets and innovative financial instruments could ultimately render a definition based on examples inadequate and obsolete. The ULC, therefore, decided to base the definition of a derivative financial instrument on a description of the common characteristics of those instruments in order to accommodate the accounting for newly developed derivatives. (Footnote omitted.)

Marking to market. A gain or loss that occurs because the trustee marks securities to market or to another value during an accounting period is not a transaction in a derivative financial instrument that is income or principal under the Act only cash receipts and disbursements, and the receipt of property in exchange for a principal asset, affect a trust's principal and income accounts.

Receipt of property other than cash. If a trustee receives property other than cash upon the settlement of a derivatives transaction, that property would be principal under Section 62-7-913(2).

Options. Options to which subsection (C) applies include an option to purchase real estate owned by the trustee and a put option purchased by a trustee to guard against a drop in value of a large block of marketable stock that must be liquidated to pay estate taxes. Subsection (C) would also apply to a continuing and regular practice of selling call options on securities owned by the trust if the terms of the option require delivery of the securities. It does not

SECTION 62-7-924. Allocation of payments related to asset-backed securities.

(A) In this section, “asset-backed security” means an asset whose value is based upon the right it gives the owner to receive distributions from the proceeds of financial assets that provide collateral for the security. The term includes an asset that gives the owner the right to receive from the collateral financial assets only the interest or other current return or only the proceeds other than interest or current return. The term does not include an asset subject to Section 62-7-909 or 62-7-918.

(B) If a trust receives a payment from interest or other current return and from other proceeds of the collateral financial assets, the trustee shall allocate to income the portion of the payment which the payer identifies as being from interest or other current return and shall allocate the balance of the payment to principal.

(C) If a trust receives one or more payments in exchange for the entire interest in an asset-backed security in one accounting period, the trustee shall allocate the payments to principal. If a payment is one of a series of payments that results in the liquidation of the interest of the trust in the security over more than one accounting period, the trustee shall allocate ten percent of the payment to income and the balance to principal.

apply if the consideration received or given for the option is something other than cash or property, such as cross-options granted in a buy-sell agreement between owners of an entity.

SECTION 62-7-924.

(A) In this section, ‘asset-backed security’ means an asset whose value is based upon the right it gives the owner to receive distributions from the proceeds of financial assets that provide collateral for the security. The term includes an asset that gives the owner the right to receive from the collateral financial assets only the interest or other current return or only the proceeds other than interest or current return. The term does not include an asset subject to Section 62-7-909 or 62-7-918.

(B) If a trust receives a payment from interest or other current return and from other proceeds of the collateral financial assets, the trustee shall allocate to income the portion of the payment which the payer identifies as being from interest or other current return and shall allocate the balance of the payment to principal.

(C) If a trust receives one or more payments in exchange for the entire interest in an asset-backed security in one accounting period, the trustee shall allocate the payments to principal. If a payment is one of a series of payments that results in the liquidation of the interest of the trust in the security over more than one accounting period, the trustee shall allocate ten percent of the payment to income and the balance to principal.

REPORTER’S COMMENT

Scope of section. Typical asset-backed securities include arrangements in which debt obligations such as real estate mortgages, credit card receivables and auto loans are acquired by an investment trust and interests in the trust are sold to investors. The source for payments to an investor is the money received from principal

<p>SECTION 62-7-925. Disbursements from income.</p> <p>A trustee shall make the following disbursements from income to the extent that they are not disbursements subject to Section 62-7-905(2)(b) or (c):</p> <ol style="list-style-type: none"> (1) one-half of the regular compensation of the trustee and of any person providing investment advisory or custodial services to the trustee; (2) one-half of all expenses for accountings, judicial proceedings, or other matters that involve both the income and remainder interests; (3) all of the other ordinary expenses incurred in connection with the administration, 	<p>and interest payments on the underlying debt. An asset-backed security includes an “interest only” or a “principal only” security that permits the investor to receive only the interest payments received from the bonds, mortgages or other assets that are the collateral for the asset-backed security, or only the principal payments made on those collateral assets. An asset-backed security also includes a security that permits the investor to participate in either the capital appreciation of an underlying security or in the interest or dividend return from such a security, such as the “Primes” and “Scores” issued by Americus Trust. An asset-backed security does not include an interest in a corporation, partnership, or an investment trust described in the Comment to Section 62-7-911 whose assets consist significantly or entirely of investment assets. Receipts from an instrument that do not come within the scope of this section or any other section of this Act would be allocated entirely to principal under the rule in Section 62-7-903(A)(4) and the trustee may then consider whether and to what extent to exercise the power to adjust in Section 62-7-904 taking into account the return from the portfolio as whole and other relevant factors.</p> <p>SECTION 62-7-925.</p> <p>A trustee shall make the following disbursements from income to the extent that they are not disbursements subject to Section 62-7-905(2)(b) or (c):</p> <ol style="list-style-type: none"> (1) one-half of the regular compensation of the trustee and of any person providing investment advisory or custodial services to the trustee; (2) one-half of all expenses for accountings, judicial proceedings, or other matters that involve both the income and remainder interests; (3) all of the other ordinary expenses incurred in connection with the administration,
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<p>management, or preservation of trust property and the distribution of income, including interest, ordinary repairs, regularly recurring taxes assessed against principal, and expenses of a proceeding or other matter that concerns primarily the income interest; and (4) recurring premiums on insurance covering the loss of a principal asset or the loss of income from or use of the asset.</p>	<p>management, or preservation of trust property and the distribution of income, including interest, ordinary repairs, regularly recurring taxes assessed against principal, and expenses of a proceeding or other matter that concerns primarily the income interest; and (4) recurring premiums on insurance covering the loss of a principal asset or the loss of income from or use of the asset.</p> <p>REPORTER’S COMMENT</p> <p>Trustee fees. The regular compensation of a trustee or the trustee’s agent includes compensation based on a percentage of either principal or income or both.</p> <p>Insurance premiums. The reference in paragraph (4) to “recurring” premiums is intended to distinguish premiums paid annually for fire insurance from premiums on title insurance, each of which covers the loss of a principal asset. Title insurance premiums would be a principal disbursement under Section 62-7-926(A)(5).</p> <p>Regularly recurring taxes. The reference to “regularly recurring taxes assessed against principal” includes all taxes regularly imposed on real property and tangible and intangible personal property.</p>
<p>SECTION 62-7-926. Disbursements from principal.</p> <p>(A) A trustee shall make the following disbursements from principal: (1) the remaining one-half of the disbursements provided in Section 62-7-925(1) and (2); (2) all of the trustee’s compensation calculated on principal as a fee for acceptance, distribution, or termination, and disbursements made to prepare property for sale; (3) payments on the principal of a trust debt; (4) expenses of a proceeding that concerns primarily principal, including a proceeding to</p>	<p>SECTION 62-7-926.</p> <p>(A) A trustee shall make the following disbursements from principal: (1) the remaining one-half of the disbursements provided in Section 62-7-925(1) and (2); (2) all of the trustee’s compensation calculated on principal as a fee for acceptance, distribution, or termination, and disbursements made to prepare property for sale; (3) payments on the principal of a trust debt; (4) expenses of a proceeding that concerns primarily principal, including a proceeding to</p>

<p>construe the trust or to protect the trust or its property;</p> <p>(5) premiums paid on a policy of insurance not provided in Section 62-7-925(4) of which the trust is the owner and beneficiary;</p> <p>(6) estate, inheritance, and other transfer taxes, including penalties, apportioned to the trust; and</p> <p>(7) disbursements related to environmental matters, including reclamation, assessing environmental conditions, remedying and removing environmental contamination, monitoring remedial activities and the release of substances, preventing future releases of substances, collecting amounts from persons liable or potentially liable for the costs of those activities, penalties imposed under environmental laws or regulations and other payments made to comply with those laws or regulations, statutory or common law claims by third parties, and defending claims based on environmental matters.</p> <p>(B) If a principal asset is encumbered with an obligation that requires income from that asset to be paid directly to the creditor, the trustee shall transfer from principal to income an amount equal to the income paid to the creditor in reduction of the principal balance of the obligation.</p>	<p>construe the trust or to protect the trust or its property;</p> <p>(5) premiums paid on a policy of insurance not provided in Section 62-7-925(4) of which the trust is the owner and beneficiary;</p> <p>(6) estate, inheritance, and other transfer taxes, including penalties, apportioned to the trust; and</p> <p>(7) disbursements related to environmental matters, including reclamation, assessing environmental conditions, remedying and removing environmental contamination, monitoring remedial activities and the release of substances, preventing future releases of substances, collecting amounts from persons liable or potentially liable for the costs of those activities, penalties imposed under environmental laws or regulations and other payments made to comply with those laws or regulations, statutory or common law claims by third parties, and defending claims based on environmental matters.</p> <p>(B) If a principal asset is encumbered with an obligation that requires income from that asset to be paid directly to the creditor, the trustee shall transfer from principal to income an amount equal to the income paid to the creditor in reduction of the principal balance of the obligation.</p> <p>REPORTER'S COMMENT</p> <p>Environmental expenses. All environmental expenses are payable from principal, subject to the power of the trustee to transfer funds to principal from income under Section 62-7-928. However, the ULC Drafting Committee decided that it was not necessary to broaden this provision to cover other expenditures made under compulsion of governmental authority. See generally the annotation at 43 A.L.R.4th 1012 (Duty as Between Life Tenant and Remainderman with Respect to Cost of Improvements or Repairs Made Under Compulsion of Governmental Authority).</p> <p>Environmental expenses paid by a trust are to</p>
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be paid from principal under Section 62-7-926(A)(7) on the assumption that they will usually be extraordinary in nature.

Environmental expenses might be paid from income if the trustee is carrying on a business that uses or sells toxic substances, in which case environmental cleanup costs would be a normal cost of doing business and would be accounted for under Section 62-7-912. In accounting under that Section, environmental costs will be a factor in determining how much of the net receipts from the business is trust income. Paying all other environmental expenses from principal is consistent with this Act's approach regarding receipts - when a receipt is not clearly a current return on a principal asset, it should be added to principal because over time both the income and remainder beneficiaries benefit from this treatment. Here, allocating payments required by environmental laws to principal imposes the detriment of those payments over time on both the income and remainder beneficiaries.

Under Sections 62-7-928(A) and (B)(5) a trustee who makes or expects to make a principal disbursement for an environmental expense described in Section 62-7-926(A)(7) is authorized to transfer an appropriate amount from income to principal to reimburse principal for disbursements made or to provide a reserve for future principal disbursements.

The first part of Section 62-7-926(A)(7) is based upon the definition of an "environmental remediation trust" in Treas. Reg. Sec 301.7701-4(e)(as amended in 1996). This is not because the Act applies to an environmental remediation trust, but because the definition is a useful and thoroughly vetted description of the kinds of expenses that a trustee owning contaminated property might incur. Expenses incurred to comply with environmental laws include the cost of environmental consultants, administrative proceedings and burdens of every kind imposed as the result of an administrative or judicial proceeding, even though the burden is not formally characterized as a penalty.

<p>SECTION 62-7-927. Transfer to principal of cash receipts from asset subject to depreciation.</p> <p>(A) In this section, “depreciation” means a reduction in value due to wear, tear, decay, corrosion, or gradual obsolescence of a fixed asset having a useful life of more than one year.</p> <p>(B) A trustee may transfer to principal a reasonable amount of the net cash receipts from a principal asset that is subject to depreciation, but may not transfer any amount for depreciation:</p> <p>(1) of that portion of real property used or available for use by a beneficiary as a residence or of tangible personal property held or made available for the personal use or enjoyment of a beneficiary;</p> <p>(2) during the administration of a decedent’s estate; or</p> <p>(3) under this section if the trustee is accounting pursuant to Section 62-7-912 for the business or activity in which the asset is used.</p> <p>(C) An amount transferred to principal need not be held as a separate fund.</p>	<p>Title proceedings. Disbursements that are made to protect a trust’s property, referred to in Section 62-7-926(A)(4) include an “action to assure title” that is mentioned in Section 13(c)(2) of the 1962 Act and Section 62-7-418(2) of the 1963 SC Act.</p> <p>Insurance premiums. Insurance premiums referred to in Section 62-7-926(A)(5) include title insurance premiums. They also include premiums on life insurance policies owned by the trust, which represent the trust’s periodic investment in the insurance policy. There is no provision in the 1962 or 1963 SC Act for life insurance premiums.</p> <p>Taxes. Generation-skipping transfer taxes are payable from principal under Section 62-7-926(A)(6).</p> <p>SECTION 62-7-927.</p> <p>(A) In this section, ‘depreciation’ means a reduction in value due to wear, tear, decay, corrosion, or gradual obsolescence of a fixed asset having a useful life of more than one year.</p> <p>(B) A trustee may transfer to principal a reasonable amount of the net cash receipts from a principal asset that is subject to depreciation, but may not transfer any amount for depreciation:</p> <p>(1) of that portion of real property used or available for use by a beneficiary as a residence or of tangible personal property held or made available for the personal use or enjoyment of a beneficiary;</p> <p>(2) during the administration of a decedent’s estate; or</p> <p>(3) under this section if the trustee is accounting pursuant to Section 62-7-912 for the business or activity in which the asset is used.</p> <p>(C) An amount transferred to principal need not be held as a separate fund.</p> <p>REPORTER’S COMMENT</p>
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<p>SECTION 62-7-928. Future principal disbursements reserves.</p> <p>(A) If a trustee makes or expects to make a principal disbursement described in this section, the trustee may transfer an appropriate amount from income to principal in one or more accounting periods to reimburse principal or to provide a reserve for</p>	<p>Prior Acts. The 1931 Act has no provision for depreciation. Sections 13(a)(2) of the 1962 Act and 62-7-417(2) of the 1963 SC Act provide that a charge shall be made against income for "... a reasonable allowance for depreciation on property subject to depreciation under generally accepted accounting principles" That provision has been resisted by many trustees, who do not provide for any depreciation for a variety of reasons. One reason relied upon is that a charge for depreciation is not needed to protect the remainder beneficiaries if the value of the land is increasing; another is that generally accepted accounting principles may not require depreciation to be taken if the property is not part of a business. The Drafting Committee for the 1997 NCCUSL Act concluded that the decision to provide for depreciation should be discretionary with the trustee. The power to transfer funds from income to principal that is granted by this section is a "discretionary power of administration" referred to in Section 62-7-903(B) and in exercising the power a trustee must comply with Section 62-7-903(B).</p> <p>One purpose served by transferring cash from income to principal for depreciation is to provide funds to pay the principal of an indebtedness secured by the depreciable property. Section 62-7-928(B)(4) permits the trustee to transfer additional cash from income to principal for this purpose to the extent that the amount transferred from income to principal for depreciation is less than the amount of the principal payments.</p> <p>SECTION 62-7-928.</p> <p>(A) If a trustee makes or expects to make a principal disbursement described in this section, the trustee may transfer an appropriate amount from income to principal in one or more accounting periods to reimburse principal or to provide a reserve for future principal</p>
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<p>future principal disbursements.</p> <p>(B) A principal disbursement for purposes of this section includes the following, but only to the extent that the trustee has not been, and does not expect to be, reimbursed by a third party:</p> <p>(1) an amount chargeable to income but paid from principal because it is unusually large, including extraordinary repairs;</p> <p>(2) a capital improvement to a principal asset, whether in the form of changes to an existing asset or the construction of a new asset, including special assessments;</p> <p>(3) a disbursement made to prepare property for rental, including tenant allowances, leasehold improvements, and broker’s commissions;</p> <p>(4) a periodic payment on an obligation secured by a principal asset to the extent that the amount transferred from income to principal for depreciation is less than the periodic payments; and</p> <p>(5) a disbursement described in Section 62-7-926(A)(7).</p> <p>(C) If the asset whose ownership gives rise to the disbursements becomes subject to a successive income interest after an income interest ends, a trustee may continue to transfer amounts from income to principal as provided in subsection (A).</p>	<p>disbursements.</p> <p>(B) A principal disbursement for purposes of this section includes the following, but only to the extent that the trustee has not been, and does not expect to be, reimbursed by a third party:</p> <p>(1) an amount chargeable to income but paid from principal because it is unusually large, including extraordinary repairs;</p> <p>(2) a capital improvement to a principal asset, whether in the form of changes to an existing asset or the construction of a new asset, including special assessments;</p> <p>(3) a disbursement made to prepare property for rental, including tenant allowances, leasehold improvements, and broker’s commissions;</p> <p>(4) a periodic payment on an obligation secured by a principal asset to the extent that the amount transferred from income to principal for depreciation is less than the periodic payments; and</p> <p>(5) a disbursement described in Section 62-7-926(A)(7).</p> <p>(C) If the asset whose ownership gives rise to the disbursements becomes subject to a successive income interest after an income interest ends, a trustee may continue to transfer amounts from income to principal as provided in subsection (A).</p> <p>REPORTER’S COMMENT</p> <p>Prior Acts. The South Carolina sources of Section 62-7-928 are: Section 62-7-417(b) of the 1963 SC Act, which permits a trustee to “regularize distributions,” if charges against income are unusually large, by using “reserves or other reasonable means” to withhold sums from income distributions; and Section 62-7-417(a)(2) of the 1963 SC Act, which authorizes a trustee to establish an allowance for depreciation out of income if principal is used for extraordinary repairs and capital improvements. [Note, however, that “special assessments” are not specifically mentioned in Section 62-7-417(a)(2) of the 1963 SC Act.]</p>
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<p><u>SECTION 62-7-929 HAS BEEN REPLACED IN EXISTING LAW BY THE PROVISIONS OF ACT 204, S. 429, 2012</u></p> <p>SECTION 62-7-929. Payment of taxes from income and principal.</p> <p>(A) A tax required to be paid by a trustee based on receipts allocated to income must be paid from income.</p> <p>(B) A tax required to be paid by a trustee based on receipts allocated to principal must be paid from principal, even if the tax is called an income tax by the taxing authority.</p> <p>(C) A tax required to be paid by a trustee on the trust’s share of the taxable income of the entity must be paid:</p> <p>(1) from income, to the extent that receipts from the entity are allocated to income;</p> <p>(2) from principal, to the extent that receipts from the entity are allocated only to principal;</p> <p>(3) proportionately from principal and income to the extent that receipts from the entity are allocated to both income and principal; and</p> <p>(4) from principal to the extent that the tax exceeds the total receipts from the entity.</p> <p>(D) After applying subsections (A) through (C), the trustee shall adjust income or principal receipts to the extent that the trust’s taxes are reduced because the trust receives a deduction for payments made to a</p>	<p>Section 12(3) of the 1931 Act permits the trustee to spread income expenses of unusual amount “throughout a series of years.” Section 62-7-928 of this Act contains a more detailed enumeration of the circumstances in which this authority may be used, and includes in subsection (B)(4) the express authority to use income to make principal payments on a mortgage if the depreciation charge against income is less than the principal payments on the mortgage.</p> <p><u>SECTION 62-7-929 HAS BEEN REPLACED IN EXISTING LAW BY THE PROVISIONS OF ACT 204, S. 429, 2012</u></p> <p>SECTION 62-7-929.</p> <p>(A) A tax required to be paid by a trustee based on receipts allocated to income must be paid from income.</p> <p>(B) A tax required to be paid by a trustee based on receipts allocated to principal must be paid from principal, even if the tax is called an income tax by the taxing authority.</p> <p>(C) A tax required to be paid by a trustee on the trust’s share of the taxable income of the entity must be paid:</p> <p>(1) from income, to the extent that receipts from the entity are allocated to income;</p> <p>(2) from principal, to the extent that receipts from the entity are allocated only to principal;</p> <p>(3) proportionately from principal and income to the extent that receipts from the entity are allocated to both income and principal; and</p> <p>(4) from principal to the extent that the tax exceeds the total receipts from the entity.</p> <p>(D) After applying subsections (A) through (C), the trustee shall adjust income or principal receipts to the extent that the trust’s taxes are reduced because the trust receives a deduction for payments made to a beneficiary.”</p> <p>REPORTER’S COMMENTS</p>
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beneficiary.”

REPORTER’S COMMENTS

Taxes on Undistributed Entity Taxable Income. When a trust owns an interest in a pass-through entity, such as a partnership or “S” corporation, it must report its share of the entity’s taxable income regardless of how much the entity distributes to the trust. Whether the entity distributes more or less than the trust’s tax on its share of the entity’s taxable income, the trust must pay the taxes and allocate them between income and principal.

Subsection (C) requires the trust to pay the taxes on its share of an entity’s taxable income from income or principal receipts to the extent that receipts from the entity are allocable to each. This assures the trust a source of cash to pay some or all of the taxes on its share of the entity’s taxable income. Subsection (D) recognizes that, except in the case of an Electing Small Business Trust (ESBT), a trust normally receives a deduction for amounts distributed to a beneficiary. Accordingly, subsection (D) requires the trust to increase receipts payable to a beneficiary as determined under subsection (C) to the extent the trust’s taxes are reduced by distributing those receipts to the beneficiary.

Because the trust’s taxes and amounts distributed to a beneficiary are interrelated, the trust may be required to apply a formula to determine the correct amount payable to a beneficiary. This formula should take into account that each time a distribution is made to a beneficiary, the trust taxes are reduced and amounts distributable to a beneficiary are increased. The formula assures that after deducting distributions to a beneficiary, the trust has enough to satisfy its taxes on its share of the entity’s taxable income as reduced by distributions to beneficiaries.

Example (1) - Trust T receives a Schedule K-1 from Partnership P reflecting taxable

Taxes on Undistributed Entity Taxable Income. When a trust owns an interest in a pass-through entity, such as a partnership or “S” corporation, it must report its share of the entity’s taxable income regardless of how much the entity distributes to the trust. Whether the entity distributes more or less than the trust’s tax on its share of the entity’s taxable income, the trust must pay the taxes and allocate them between income and principal.

Subsection (C) requires the trust to pay the taxes on its share of an entity’s taxable income from income or principal receipts to the extent that receipts from the entity are allocable to each. This assures the trust a source of cash to pay some or all of the taxes on its share of the entity’s taxable income. Subsection (D) recognizes that, except in the case of an Electing Small Business Trust (ESBT), a trust normally receives a deduction for amounts distributed to a beneficiary. Accordingly, subsection (D) requires the trust to increase receipts payable to a beneficiary as determined under subsection (C) to the extent the trust’s taxes are reduced by distributing those receipts to the beneficiary.

Because the trust’s taxes and amounts distributed to a beneficiary are interrelated, the trust may be required to apply a formula to determine the correct amount payable to a beneficiary. This formula should take into account that each time a distribution is made to a beneficiary, the trust taxes are reduced and amounts distributable to a beneficiary are increased. The formula assures that after deducting distributions to a beneficiary, the trust has enough to satisfy its taxes on its share of the entity’s taxable income as reduced by distributions to beneficiaries.

Example (1) - Trust T receives a Schedule K-1 from Partnership P reflecting taxable income of \$1 million. Partnership P distributes \$100,000 to T, which allocates the receipts to income. Both Trust T and income Beneficiary B are in the 35 percent tax bracket.

Trust T’s tax on \$1 million of taxable income

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Trust T's tax on \$1 million of taxable income is \$350,000. Under subsection (C) T's tax must be paid from income receipts because receipts from the entity are allocated only to income. Therefore, T must apply the entire \$100,000 of income receipts to pay its tax. In this case, Beneficiary B receives nothing.

Example (2) - Trust T receives a Schedule K-1 from Partnership P reflecting taxable income of \$1 million. Partnership P distributes \$500,000 to T, which allocates the receipts to income. Both Trust T and income Beneficiary B are in the 35 percent tax bracket.

Trust T's tax on \$1 million of taxable income is \$350,000. Under subsection (C), T's tax must be paid from income receipts because receipts from P are allocated only to income. Therefore, T uses \$350,000 of the \$500,000 to pay its taxes and distributes the remaining \$150,000 to B. The \$150,000 payment to B reduces T's taxes by \$52,500, which it must pay to B. But the \$52,500 further reduces T's taxes by \$18,375, which it also must pay to B. In fact, each time T makes a distribution to B, its taxes are further reduced, causing another payment to be due B.

Alternatively, T can apply the following algebraic formula to determine the amount payable to B:

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

- 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

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Applying the formula to Example (2) above, Trust T must pay \$230,769 to B so that after deducting the payment, T has exactly enough to pay its tax on the remaining taxable income from P.

Taxable Income per K-1	
\$1,000,000	
Payment to beneficiary	\$230,769

[1]

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

In addition, B will report \$230,769 on his or her own personal income tax return, paying taxes of \$80,769. Because Trust T withheld \$269,231 to pay its taxes and B paid \$80,769 taxes of its own, B bore the entire \$350,000 tax burden on the \$1 million of entity taxable income, including the \$500,000 that the entity retained that presumably increased the value of the trust's investment entity.

If a trustee determines that it is appropriate to do so, it should consider exercising the discretion granted in Section 62-7-930 to adjust between income and principal. Alternatively, the trustee may exercise the power to adjust under Section 62-7-904 to the extent it is available and appropriate under the circumstances, including whether a future distribution from the entity that would be allocated to principal should be reallocated to income because the income beneficiary already bore the burden of taxes on the reinvested income. In exercising the power, the trust should consider the impact that future distributions will have on any current adjustments.

Trust Taxable Income	\$769,231
35 percent tax	\$269,231
Partnership Distribution	\$500,000
Fiduciary's Tax Liability	
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Payable to the Beneficiary	\$230,769

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[1] $D = (C - R * K) / (1 - R) = (500,000 - 350,000) / (1 - .35) = \$230,769$. (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)

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SECTION 62-7-930. Certain adjustments between principal and income; reduction of marital deduction or charitable contribution deduction.

(A) A fiduciary may make adjustments between principal and income to offset the shifting of economic interests or tax benefits between income beneficiaries and remainder beneficiaries which arise from:

(1) elections and decisions, other than those provided in subsection (B), that the fiduciary makes from time to time regarding tax matters;

(2) an income tax or any other tax that is imposed upon the fiduciary or a beneficiary as a result of a transaction involving or a distribution from the estate or trust; or

(3) the ownership by an estate or trust of an interest in an entity whose taxable income, whether or not distributed, is includable in the taxable income of the estate, trust, or a beneficiary.

(B) If the amount of an estate tax marital deduction 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 shall reimburse the principal from which the increase in estate tax is paid. The total reimbursement must equal the increase in the estate tax to the extent that the principal used

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to pay the increase would have qualified for a marital deduction or charitable contribution deduction but for the payment. The proportionate share of the reimbursement for each estate, trust, or beneficiary whose income taxes are reduced must be the same as its proportionate share of the total decrease in income tax. An estate or trust shall reimburse principal from income.

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REPORTER'S COMMENT

Discretionary adjustments. Section 62-7-930(A) permits the fiduciary to make adjustments between income and principal because of tax law provisions. It would permit discretionary adjustments in situations like these: (1) A fiduciary elects to deduct administration expenses that are paid from principal on an income tax return instead of on the estate tax return; (2) 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 (3) 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. See generally Joel C. Dobris, *Limits on the Doctrine of Equitable Adjustment in Sophisticated Postmortem Tax Planning*, 66 *Iowa L. Rev.* 273 (1981).

Section 62-7-930(A)(3) applies to a qualified Subchapter S trust (QSST) whose income beneficiary is required to include a pro rata share of the S corporation's taxable income in his return. If the QSST does not receive a cash distribution from the corporation that is large enough to cover the income beneficiary's tax liability, the trustee may distribute additional cash from principal to the income beneficiary.

In this case the retention of cash by the corporation benefits the trust principal. This situation could occur if the corporation's taxable income includes capital gain from the sale of a business asset and the sale proceeds are reinvested in the business instead of being distributed to shareholders.

Mandatory adjustment. Section 62-7-930(B) provides for a mandatory adjustment from income to principal to the extent needed to preserve an estate tax marital deduction or charitable contributions deduction. It is derived from New York's EPTL Sec 11-1.2(A), which requires principal to be reimbursed by those who benefit when a fiduciary elects to deduct administration expenses on an income tax return instead of the estate tax return. Unlike the New York provision, Section 62-7-930(B) limits a mandatory reimbursement to cases in which a marital deduction or a charitable contributions deduction is reduced by the payment of additional estate taxes because of the fiduciary's income tax election. It is intended to preserve the result reached in *Estate of Britenstool v. Commissioner*, 46 T.C. 711 (1966), in which the Tax Court held that a reimbursement required by the predecessor of EPTL Sec 11-1.2(A) resulted in the estate receiving the same charitable contributions deduction it would have received if the administration expenses had been deducted for estate tax purposes instead of for income tax purposes. Because a fiduciary will elect to deduct administration expenses for income tax purposes only when the income tax reduction exceeds the estate tax reduction, the effect of this adjustment is that the principal is placed in the same position it would have occupied if the fiduciary had deducted the expenses for estate tax purposes, but the income beneficiaries receive an additional benefit. For example, if the income tax benefit from the deduction is \$30,000 and the estate tax benefit would have been \$20,000, principal will be reimbursed \$20,000 and the net benefit to the income beneficiaries will be \$10,000.

Irrevocable grantor trusts. Under Sections

671-679 of the Internal Revenue Code (the “grantor trust” provisions), a person who creates an irrevocable trust for the benefit of another person may be subject to tax on the trust’s income or capital gains, or both, even though the settlor is not entitled to receive any income or principal from the trust. Because this is now a well-known tax result, many trusts have been created to produce this result, but there also may be trusts that are unintentionally subject to this rule. The Act does not require or authorize a trustee to distribute funds from the trust to the settlor in these cases because it is difficult to establish a rule that applies only to trusts where this tax result is unintended and does not apply to trusts where the tax result is intended. Settlers who intend this tax result rarely state it as an objective in the terms of the trust, but instead rely on the operation of the tax law to produce the desired result. As a result it may not be possible to determine from the terms of the trust if the result was intentional or unintentional. Where the drafter of such a trust wants the trustee to have the authority to distribute principal or income to the settlor to reimburse the settlor for taxes paid on the trust’s income or capital gains, such a provision should be placed in the terms of the trust. In some situations the Internal Revenue Service may require that such a provision be placed in the terms of the trust as a condition to issuing a private letter ruling.

SECTION 62-7-931. Application and construction of Uniform Principal and Income Act.

In applying and construing this Uniform Act, consideration must be given to the need to promote uniformity of the law with respect to its subject matter among states that enact it.

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SECTION 62-7-932. Discretionary power of a fiduciary.

(A) A court must not change a fiduciary's decision to exercise or not to exercise a discretionary power conferred by this part unless it determines that the decision was an abuse of the fiduciary's discretion. A court shall not determine that a fiduciary abused its discretion merely because the court would have exercised the discretion in a different manner or would not have exercised the discretion.

(B) The decisions subject to subsection (A) include a determination:

(1) pursuant to Section 62-7-904(A) of whether and to what extent an amount should be transferred from principal to income or from income to principal; and

(2) of the factors that are relevant to the trust and its beneficiaries, the extent to which they are relevant, and the weight, if any, to be given to the relevant factors, in deciding whether and to what extent to exercise the power in Section 62-7-904(A).

(C) If a court determines that a fiduciary has abused its discretion, the remedy is to restore the income and remainder beneficiaries to the positions they would have occupied if the fiduciary had not abused its discretion, according to the following rules:

(1) to the extent that the abuse of discretion has resulted in no distribution to a beneficiary or a distribution that is too small, the court must require the fiduciary to distribute from the trust to the beneficiary an amount that the court determines will restore the beneficiary, in whole or in part, to his or her appropriate position;

(2) to the extent that the abuse of discretion has resulted in a distribution to a beneficiary that is too large, the court must restore the beneficiaries, the trust, or both, in whole or in part, to their appropriate positions by requiring the fiduciary to withhold an amount from one or more future distributions to the

SECTION 62-7-932.

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<p>beneficiary who received the distribution that was too large or requiring that beneficiary to return some or all of the distribution to the trust;</p> <p>(3) to the extent that the court is unable, after applying items (1) and (2), to restore the beneficiaries, the trust, or both, to the positions they would have occupied if the fiduciary had not abused its discretion, the court may require the fiduciary to pay an appropriate amount from its own funds to one or more of the beneficiaries or the trust, or both.</p> <p>(D) Upon a petition by the fiduciary, the court having jurisdiction over the trust or estate must determine whether a proposed exercise or nonexercise by the fiduciary of a discretionary power in this part results in an abuse of the fiduciary's discretion. If the petition describes the proposed exercise or nonexercise of the power and contains sufficient information to inform the beneficiaries of the reasons for the proposal, the facts upon which the fiduciary relies, and an explanation of how the income and remainder beneficiaries are affected by the proposed exercise or nonexercise of the power, a beneficiary who challenges the proposed exercise or nonexercise has the burden of establishing that it will result in an abuse of discretion.</p>	<p>was too large or requiring that beneficiary to return some or all of the distribution to the trust;</p> <p>(3) to the extent that the court is unable, after applying items (1) and (2), to restore the beneficiaries, the trust, or both, to the positions they would have occupied if the fiduciary had not abused its discretion, the court may require the fiduciary to pay an appropriate amount from its own funds to one or more of the beneficiaries or the trust, or both.</p> <p>(D) Upon a petition by the fiduciary, the court having jurisdiction over the trust or estate must determine whether a proposed exercise or nonexercise by the fiduciary of a discretionary power in this part results in an abuse of the fiduciary's discretion. If the petition describes the proposed exercise or nonexercise of the power and contains sufficient information to inform the beneficiaries of the reasons for the proposal, the facts upon which the fiduciary relies, and an explanation of how the income and remainder beneficiaries are affected by the proposed exercise or nonexercise of the power, a beneficiary who challenges the proposed exercise or nonexercise has the burden of establishing that it will result in an abuse of discretion. <u>RESERVED</u></p>
<p>Article 7. Part 9A (NOT SEPARATE PART IN EXISTING LAW)</p>	<p>Article 7. Part 9A SC Uniform Prudent Investor Act</p>
	<p>General Comment</p> <p>Effective July 18, 2001, South Carolina enacted as part of its Uniform Probate Code (SCPC) the South Carolina Uniform Prudent Investor Act (SCUPIA), Section 62-7-302. This is South Carolina's version of the Uniform Prudent Investor Act (UPIA) which was enacted and recommended in 1994 by the Uniform Law Commission (ULC) for enactment in all the states. UPIA consists of 16 separate sections, the first ten of which are each followed by a separate ULC Comment; whereas, SCUPIA is a</p>

single section (multi-subsection) consolidation of (1) UPIA's first ten sections but without any of the ULC Comments, (2) two other UPIA sections which have never had any comments (Sections 12, "Uniformity of Application and Construction" and 13, "Short Title") and (3) two new subsections which are not in UPIA and have never had any comments (SCUPIA subsections (J) and (K)). The remaining four sections of UPIA are not in SCUPIA and have never had any comments. Thus, prior to 2005 SCUPIA had no ULC Comments. When in 2005 South Carolina enacted its version of ULC's recommended 2000 Uniform Trust Code as the South Carolina Trust Code (SCTC), SC Code Title 62, Article 7, SCUPIA was retained, re-numbered and incorporated at SCTC Section 62-7-933, but still without any ULC Comments. Now, with this 2012 (or "current") amendment, the ULC Comments are consolidated into a single Comment drafted specifically for South Carolina purposes and inserted immediately following SCUPIA. Again, any reference elsewhere in the South Carolina Code to former SCPC Section 62-7-302 should now refer to SCTC Section 62-7-933.

When in 2005 SCUPIA was retained, re-numbered and incorporated at SCTC Section 62-7-933, certain subsections of SCUPIA as it had been originally enacted in 2001 (SCPC Section 62-7-302) were deleted as recommended by ULC because they were duplicative of provisions in the newly enacted SCTC: former SCPC Section 62-7-302(C)(6), (F), and (H). The correlative provisions of SCTC, which govern investment, management, and distribution of trust assets (i.e., trust administration), are broader in perspective than the deleted SCPC subsections, which governed only investment and management of trust assets. SCTC Section 62-7-933(C)(5)(c) retains and incorporates former SCPC Section 62-7-602.

Over the quarter century from the late 1960's to the early 1990s the investment practices of fiduciaries experienced significant change. ULC's Uniform Prudent Investor Act (UPIA)

undertakes to update trust investment law in recognition of the alterations that have occurred in investment practice. These changes have occurred under the influence of a large and broadly accepted body of empirical and theoretical knowledge about the behavior of capital markets, often described as “modern portfolio theory.”

UPIA, now enacted in South Carolina as SCUPIA at Section 62-7-933, draws upon the revised standards for prudent trust investment promulgated by the American Law Institute in its Restatement (Third) of Trusts: Prudent Investor Rule (1992) [hereinafter Restatement of Trusts 3d: Prudent Investor Rule; also referred to as 1992 Restatement]. [Since the early 1990’s when the uniform version of this Prefatory Note and the following Comments were prepared by ULC, Restatement of Trusts 3d has progressed significantly as reported in the Forenote to Chapter 17 of what is now cited as “Restatement Third, Trusts”:

The contents of this Chapter (Introduction and Sections 90-92) were approved at the American Law Institute’s 1990 Annual Meeting and were originally published as Sections 227-229 of Restatement Third, Trusts (Prudent Investor Rule) in 1992 [*referred to throughout this SCUPIA Prefatory Note and the following Comments as either “Restatement of Trusts 3d: Prudent Investor Rule” or simply “1992 Restatement”*]. The “prudent investor rule” is incorporated here without substantive change, with some updating of the Reporter’s Notes, adaptation of cross-references to reflect the new numbering and content of other Trust Third Sections, and adaptation of some wording to reflect the passage of time and interim developments, particularly the widespread substitution of prudent-investor principles for prior law.

Therefore, appropriate reference to Chapter 17 (Introduction and Sections 90-92) of Restatement Third, Trusts is suggested.]

Objectives of the Act. SCUPIA makes five fundamental alterations in the former criteria for

prudent investing. All are to be found in the Restatement of Trusts 3d: Prudent Investor Rule.

(1) The standard of prudence is applied to any investment as part of the total portfolio, rather than to individual investments. In the trust setting the term “portfolio” embraces all the trust’s assets. SCUPIA Subsection (C)(2).

(2) The tradeoff in all investing between risk and return is identified as the fiduciary’s central consideration. SCUPIA Subsection (C)(2).

(3) All categoric restrictions on types of investments have been abrogated; the trustee can invest in anything that plays an appropriate role in achieving the risk/return objectives of the trust and that meets the other requirements of prudent investing. SCUPIA Subsection (C)(5)(a).

(4) The long familiar requirement that fiduciaries diversify their investments has been integrated into the definition of prudent investing. SCUPIA Subsection (D).

(5) The much criticized former rule of trust law forbidding the trustee to delegate investment and management functions has been reversed. Delegation is now permitted, subject to safeguards. SCUPIA Subsection (J).

Literature. These changes in trust investment law have been presaged in an extensive body of practical and scholarly writing. See especially the discussion and reporter’s notes by Edward C. Halbach, Jr., in Restatement of Trusts 3d: Prudent Investor Rule (1992); see also Edward C. Halbach, Jr., Trust Investment Law in the Third Restatement, 27 Real Property, Probate & Trust J. 407 (1992); Bevis Longstreth, Modern Investment Management and the Prudent Man Rule (1986); Jeffrey N. Gordon, The Puzzling Persistence of the Constrained Prudent Man Rule, 62 N.Y.U.L. Rev. 52 (1987); John H. Langbein & Richard A. Posner, The Revolution in Trust Investment Law, 62 A.B.A.J. 887 (1976); Note, The Regulation of Risky Investments, 83 Harvard L. Rev. 603 (1970). A succinct account of the main findings of modern portfolio theory, written for lawyers, is Jonathan

R. Macey, *An Introduction to Modern Financial Theory* (1991) (American College of Trust & Estate Counsel Foundation). A leading introductory text on modern portfolio theory is R.A. Brealey, *An Introduction to Risk and Return from Common Stocks* (2d ed. 1983).

Legislation. Most states have had legislation governing trust-investment law for many years. This Act promotes uniformity of state law on the basis of the new consensus reflected in the Restatement of Trusts 3d: Prudent Investor Rule. Some states had already acted. California, Delaware, Georgia, Minnesota, South Carolina, Tennessee, and Washington revised their prudent investor legislation to emphasize the total-portfolio standard of care in advance of the 1992 Restatement. These statutes are extracted and discussed in Restatement of Trusts 3d: Prudent Investor Rule § 227, reporter's note, at 60-66 (1992). Although South Carolina took such action in 1990 by amending SC Code Section 62-7-302, the South Carolina revision was not extracted and discussed in the 1992 Restatement.

Remedies. This Act does not undertake to address issues of remedy law or the computation of damages in trust matters. Remedies are the subject of a reasonably distinct body of doctrine. See generally Restatement (Second) of Trusts §§ 197-226A (1959) [hereinafter cited as Restatement of Trusts 2d; also referred to as 1959 Restatement]. [With the enactment of the South Carolina Trust Code in 2005, however, remedies and damages for breach of trust are addressed. SCTC Part 10.]

Implications for charitable and pension trusts. This Act is centrally concerned with the investment responsibilities arising under the private gratuitous trust, which is the common vehicle for conditioned wealth transfer within the family. Nevertheless, the prudent investor rule also bears on charitable and pension trusts, among others. "*In making investments of trust funds the trustee of a charitable trust is under a duty similar to that of the trustee of a private trust.*" Restatement of Trusts 2d § 389 (1959).

The Employee Retirement Income Security Act (ERISA), the federal regulatory scheme for pension trusts enacted in 1974, absorbs trust-investment law through the prudence standard of ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a). The Supreme Court has said: “ERISA’s legislative history confirms that the Act’s fiduciary responsibility provisions ‘codif[y] and mak[e] applicable to [ERISA] fiduciaries certain principles developed in the evolution of the law of trusts.’” *Firestone Tire & Rubber Co. v. Bruch*, 489 U.S. 101, 110-11 (1989) (footnote omitted).

Other fiduciary relationships. The South Carolina Uniform Prudent Investor Act (SCUPIA) regulates the investment responsibilities of trustees. Other fiduciaries - such as executors, conservators, and guardians of the property - sometimes have responsibilities over assets that are governed by the standards of prudent investment. It will often be appropriate for states to adapt the law governing investment by trustees under this Act to these other fiduciary regimes, taking account of such changed circumstances as the relatively short duration of most executorships and the intensity of court supervision of conservators and guardians in some jurisdictions. The present Act does not undertake to adjust trust-investment law to the special circumstances of the state schemes for administering decedents’ estates or conducting the affairs of protected persons. In South Carolina two other SC Code sections have been enacted for this purpose:

(1) Section 62-5-414.

In the exercise of his powers, a conservator is to act as a fiduciary and shall observe the standards of care applicable to trustees as described by Section 62-7-933 (SCUPIA).

(2) Section 62-3-703

(a) A personal representative is a fiduciary who ... shall observe the standards of care as described by Section 62-7-804.

(3) Both of these sections referred to Section 62-7-933 (SCUPIA) until 2010 when Section 62-3-703 was amended by replacing Section

62-7-933 with Section 62-7-804. Prudent administration -

A trustee shall administer the trust as a prudent person would, by considering the purposes, terms, distributional requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.

(4) The Comments to the SCTC point out that Section 62-7-804 is “similar to” SCUPIA and recognizes that trust “administration” includes a trustee’s “distribution to beneficiaries” *in addition to* a trustee’s investment and management of trust assets.]

Although SCUPIA by its terms applies to trusts and not to charitable corporations, the standards of the Act can be expected to inform the investment responsibilities of directors and officers of charitable corporations. As the 1992 Restatement observes, “*the duties of the members of the governing board of a charitable corporation are generally similar to the duties of the trustee of a charitable trust.*” Restatement of Trusts 3d: Prudent Investor Rule § 379, Comment *b*, at 190 (1992). See also *id.* § 389, Comment *b*, at 190-91 (absent contrary statute or other provision, prudent investor rule applies to investment of funds held for charitable corporations).

[It is interesting to note that the ULC did not mention, on this investment point, in the 1994 UPIA Prefatory Note its earlier 1972 Uniform Management of Institutional Funds Act (UMIFA). This is probably explained by the following contrary view expressed in the 1972 Comment following UMIFA Section 6:

The section establishes a standard of care and prudence for a member of a governing board. The standard is generally comparable to that of a director of a business corporation rather than that of a private trustee, but it is cast in terms of the duties and responsibilities of a manager of a nonprofit institution.

Officers of a corporation owe a duty of care and loyalty to the corporation, and the more intimate the knowledge of the affairs of the

<p>SECTION 62-7-933. Uniform Prudent Investor Act.</p> <p>(A) This section may be cited as the South Carolina Uniform Prudent Investor Act.</p> <p>(B)(1) Except as otherwise provided in item (2), a trustee who invests and manages trust assets owes a duty to the beneficiaries of the trust to comply with the prudent investor rule in this section.</p> <p>(2) The prudent investor rule is a default rule that may be expanded, restricted, eliminated, or otherwise altered by the provisions of a trust. A trustee is not liable to a beneficiary to the extent that the trustee acted in reasonable reliance on the provisions of the trust.</p> <p>(C)(1) A trustee shall invest and manage trust assets as a prudent investor would by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.</p>	<p><i>corporation the higher the standard of care. Directors are obligated to act in the utmost good faith and to exercise ordinary business care and prudence in all matters affecting the management of the corporation. This is a proper standard for the managers of a nonprofit institution, whether or not it is incorporated.</i></p> <p>Not until 2000 did South Carolina enact the South Carolina Uniform Management of Institutional Funds Act (SCUMIFA). Then in 2006 the ULC approved and recommended the Uniform Prudent Management of Institutional Funds Act (UPMIFA) which South Carolina enacted in 2008 as the South Carolina Uniform Prudent Management of Institutional Funds Act (SCUPMIFA), Sections 34-6-10 through 100. Many of SCUPIA’s provisions are in SCUPMIFA which is described by ULC as “bringing the law governing charitable institutions in line with modern investment and expenditure practice”.]</p> <p>SECTION 62-7-933.</p> <p>(A) This section may be cited as the South Carolina Uniform Prudent Investor Act, <u>or this act.</u></p> <p>(B)(1) Except as otherwise provided in item (2) <u>of this subsection</u>, a trustee who invests and manages trust assets owes a duty to the beneficiaries of the trust to comply with the prudent investor rule in this section <u>act.</u></p> <p>(2) The prudent investor rule is a default rule that may be expanded, restricted, eliminated, or otherwise altered by the provisions of a trust. A trustee is not liable to a beneficiary to the extent that the trustee acted in reasonable reliance on the provisions of the trust.</p> <p>(C)(1) A trustee shall invest and manage trust assets as a prudent investor would by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.</p>
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<p>(2) A trustee’s investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust.</p> <p>(3) Among other circumstances provided in item (1) of this subsection which a trustee shall consider in investing and managing trust assets are such of the following as are relevant to the trust or its beneficiaries:</p> <p>(a) general economic conditions;</p> <p>(b) the possible effect of inflation or deflation;</p> <p>(c) the expected tax consequences of investment decisions or strategies;</p> <p>(d) the role that each investment or course of action plays within the overall trust portfolio, including financial assets, interests in closely held enterprises, tangible and intangible personal property, and real property;</p> <p>(e) the expected total return from income and the appreciation of capital;</p> <p>(f) other resources of the beneficiaries;</p> <p>(g) needs for liquidity, regularity of income, and preservation or appreciation of capital; and</p> <p>(h) an asset’s special relationship or special value to the purposes of the trust or to one or more of the beneficiaries.</p> <p>(4) trustee shall make a reasonable effort to verify facts relevant to the investment and management of trust assets.</p> <p>(5)(a) A trustee may invest in any kind of property or type of investment consistent with the standards of this section.</p> <p>(b) Nothing in this section prohibits affiliate investments if they otherwise comply with the standards of this section. For these purposes, “ affiliate” means an entity that owns or is owned by the trustee, in whole or in part, or is owned by the same entity that owns the trustee. Affiliate investments include:</p> <p>(i) investment and reinvestment in the securities of an open-end or closed-end</p>	<p>(2) A trustee’s investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust.</p> <p>(3) Among other circumstances provided in item (1) of this subsection which a trustee shall consider in investing and managing trust assets are such of the following as are relevant to the trust or its beneficiaries:</p> <p>(a) general economic conditions;</p> <p>(b) the possible effect of inflation or deflation;</p> <p>(c) the expected tax consequences of investment decisions or strategies;</p> <p>(d) the role that each investment or course of action plays within the overall trust portfolio, including financial assets, interests in closely held enterprises, tangible and intangible personal property, and real property;</p> <p>(e) the expected total return from income and the appreciation of capital;</p> <p>(f) other resources of the beneficiaries;</p> <p>(g) needs for liquidity, regularity of income, and preservation or appreciation of capital; and</p> <p>(h) an asset’s special relationship or special value to the purposes of the trust or to one or more of the beneficiaries.</p> <p>(4) <u>A</u> trustee shall make a reasonable effort to verify facts relevant to the investment and management of trust assets.</p> <p>(5)(a) A trustee may invest in any kind of property or type of investment consistent with the standards of this section <u>act</u>.</p> <p>(b) Nothing in this section <u>act</u> prohibits affiliate investments if they otherwise comply with the standards of this section <u>act</u>. For these purposes, ‘affiliate’ means an entity that owns or is owned by the trustee, in whole or in part, or is owned by the same entity that owns the trustee. Affiliate investments include:</p> <p>(i) investment and reinvestment in the securities of an open-end or closed-end</p>
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management investment company or of an investment trust registered under the Investment Company Act of 1940, as amended. A bank or trustee, or both of them, may invest in these securities even if the bank or trustee, or an affiliate of the bank or trustee, provides services to the investment company or investment trust such as that of an investment advisor, custodian, transfer agent, registrar, sponsor, distributor, manager, or otherwise, and receives reasonable remuneration for those services;

(ii) retention of the securities into which corporate securities owned by the trustee may be converted or which may be derived as a result of merger, consolidation, stock dividends, splits, liquidations, and similar procedures, and the exercise by purchase or otherwise any rights, warrants, or conversion features attaching to the securities;

(iii) purchase or other acquisition and retention of a security underwritten by a syndicate, even if the trustee or its affiliate participates or has participated as a member of the syndicate, provided the trustee does not purchase the security from itself, its affiliate, or from another member of the underwriting syndicate, or its affiliate, pursuant to an implied or express reciprocal agreement between the trustee, or its affiliate, and the other member, or its affiliate, to purchase all or part of each other's underwriting participation commitment within the syndicate.

(c) Notwithstanding any other provision of law, any fiduciary holding securities in its fiduciary capacity, any bank, trust company, or private banker holding securities as a custodian or managing agent, and any bank, trust company, or private banker holding securities as custodian for a fiduciary, is authorized to deposit or arrange for the deposit of such securities in a clearing corporation (as defined in Article 8 of the Uniform Commercial Code). When such securities are so deposited, certificates

management investment company or of an investment trust registered under the Investment Company Act of 1940, as amended. A bank or trustee, or both of them, may invest in these securities even if the bank or trustee, or an affiliate of the bank or trustee, provides services to the investment company or investment trust such as that of an investment advisor, custodian, transfer agent, registrar, sponsor, distributor, manager, or otherwise, and receives reasonable remuneration for those services;

(ii) retention of the securities into which corporate securities owned by the trustee may be converted or which may be derived as a result of merger, consolidation, stock dividends, splits, liquidations, and similar procedures, and the exercise by purchase or otherwise any rights, warrants, or conversion features attaching to the securities;

(iii) purchase or other acquisition and retention of a security underwritten by a syndicate, even if the trustee or its affiliate participates or has participated as a member of the syndicate, provided the trustee does not purchase the security from itself, its affiliate, or from another member of the underwriting syndicate, or its affiliate, pursuant to an implied or express reciprocal agreement between the trustee, or its affiliate, and the other member, or its affiliate, to purchase all or part of each other's underwriting participation commitment within the syndicate.

(c) Notwithstanding any other provision of law, any fiduciary holding securities in its fiduciary capacity, any bank, trust company, or private banker holding securities as a custodian or managing agent, and any bank, trust company, or private banker holding securities as custodian for a fiduciary, is authorized to deposit or arrange for the deposit of such securities in a clearing corporation, (as defined in Article 8 of the Uniform Commercial Code). When such securities are so deposited, certificates representing securities of the same class of the same issuer may be merged and held in bulk in the name of the nominee of such

<p>representing securities of the same class of the same issuer may be merged and held in bulk in the name of the nominee of such clearing corporation with any other such securities deposited in such clearing corporation by any person regardless of the ownership of such securities, and certificates of small denomination may be merged into one or more certificates of larger denomination. The records of such fiduciary and the records of such bank, trust company, or private banker acting as custodian, as managing agent or as custodian for a fiduciary shall at all times show the name of the party for whose account the securities are so deposited. Ownership of, and other interests in, such securities may be transferred by bookkeeping entry on the books of such clearing corporation without physical delivery of certificates representing such securities. A bank, trust company, or private banker so depositing securities pursuant to this section shall be subject to such regulations as in the case of state-chartered institutions, the Board of Financial Institutions, and, in the case of national banking associations, The Comptroller of the Currency may from time to time issue. A bank, trust company, or private banker acting as custodian for a fiduciary shall, on demand by the fiduciary, certify in writing to the fiduciary the securities so deposited by such bank, trust company, or private banker in such clearing corporation for the account of such fiduciary. A fiduciary shall, on demand by any party to a judicial proceeding for the settlement of such fiduciary's account or on demand by the attorney for such party, certify in writing to such party the securities deposited by such fiduciary in such clearing corporation for its account as such fiduciary. This subsection shall apply to any fiduciary holding securities in its fiduciary capacity, and to any bank, trust company, or private banker holding securities as a custodian, managing agent, or custodian for a fiduciary, acting on April 17, 1973, or</p>	<p>clearing corporation with any other such securities deposited in such clearing corporation by any person regardless of the ownership of such securities, and certificates of small denomination may be merged into one or more certificates of larger denomination. The records of such fiduciary and the records of such bank, trust company, or private banker acting as custodian, as managing agent or as custodian for a fiduciary shall at all times show the name of the party for whose account the securities are so deposited. Ownership of, and other interests in, such securities may be transferred by bookkeeping entry on the books of such clearing corporation without physical delivery of certificates representing such securities. A bank, trust company, or private banker so depositing securities pursuant to this section shall be subject to such regulations as in the case of state-chartered institutions, the Board of Financial Institutions, and, in the case of national banking associations, The Comptroller of the Currency may from time to time issue. A bank, trust company, or private banker acting as custodian for a fiduciary shall, on demand by the fiduciary, certify in writing to the fiduciary the securities so deposited by such bank, trust company, or private banker in such clearing corporation for the account of such fiduciary. A fiduciary shall, on demand by any party to a judicial proceeding for the settlement of such fiduciary's account or on demand by the attorney for such party, certify in writing to such party the securities deposited by such fiduciary in such clearing corporation for its account as such fiduciary. This subsection shall apply to any fiduciary holding securities in its fiduciary capacity, and to any bank, trust company, or private banker holding securities as a custodian, managing agent, or custodian for a fiduciary, acting on April 17, 1973, or who thereafter may act regardless of the date of the agreement, instrument, or court order by which it is appointed and regardless of whether or not such fiduciary, custodian, managing agent, or custodian for a fiduciary owns capital stock of</p>
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<p>who thereafter may act regardless of the date of the agreement, instrument, or court order by which it is appointed and regardless of whether or not such fiduciary, custodian, managing agent, or custodian for a fiduciary owns capital stock of such clearing corporation.</p> <p>(6) [RESERVED]</p> <p>(D) A trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying.</p> <p>(E) Within a reasonable time after accepting a trusteeship or receiving trust assets, a trustee shall review the trust assets and make and implement decisions concerning the retention and disposition of assets in order to bring the trust portfolio into compliance with the purposes, terms, distribution requirements, and other circumstances of the trust and with the requirements of this section.</p> <p>(F) [RESERVED]</p> <p>(G) Compliance with the prudent investor rule is determined in light of the facts and circumstances existing at the time of a trustee's decision or action and not by hindsight.</p> <p>(H) [RESERVED]</p> <p>(I) The following terms or comparable language in the provisions of a trust, unless otherwise limited or modified, authorize any investment or strategy permitted pursuant to this section: "investments permissible by law for investment of trust funds", "legal investments", "authorized investments", "using the judgment and care under the circumstances then prevailing that persons of prudence, discretion, and intelligence exercise in the management of their own affairs, not in regard to speculation but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of their capital", "prudent man rule", "prudent trustee rule", "prudent person rule", and "prudent investor rule".</p>	<p>such clearing corporation.</p> <p>(6) {RESERVED}</p> <p>(D) A trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying.</p> <p>(E) Within a reasonable time after accepting a trusteeship or receiving trust assets, a trustee shall review the trust assets and make and implement decisions concerning the retention and disposition of assets in order to bring the trust portfolio into compliance with the purposes, terms, distribution requirements, and other circumstances of the trust and with the requirements of this section <u>act</u>.</p> <p>(F) {RESERVED}</p> <p>(G) Compliance with the prudent investor rule is determined in light of the facts and circumstances existing at the time of a trustee's decision or action and not by hindsight.</p> <p>(H) {RESERVED}</p> <p>(I) The following terms or comparable language in the provisions of a trust, unless otherwise limited or modified, authorize any investment or strategy permitted pursuant to this section <u>act</u>: 'investments permissible by law for investment of trust funds', 'legal investments', 'authorized investments', 'using the judgment and care under the circumstances then prevailing that persons of prudence, discretion, and intelligence exercise in the management of their own affairs, not in regard to speculation but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of their capital', 'prudent man rule', 'prudent trustee rule', 'prudent person rule', and 'prudent investor rule'.</p> <p>(J)(1) Notwithstanding provisions of this section <u>act</u> to the contrary, the duties of a trustee with respect to acquiring a contract of insurance upon the life of the trustor or upon the lives of the trustor and the trustor's spouse, children, or parents do not include a duty to:</p> <p>(a) determine whether the contract is or</p>
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<p>(J)(1) Notwithstanding provisions of this section to the contrary, the duties of a trustee with respect to acquiring a contract of insurance upon the life of the trustor or upon the lives of the trustor and the trustor’s spouse, children, or parents do not include a duty to:</p> <p>(a) determine whether the contract is or remains a proper investment;</p> <p>(b) exercise policy options available under the contract; or</p> <p>(c) diversify the contract.</p> <p>(2) The trustee is not liable to the beneficiaries of the contract of insurance or to another party for loss arising from this subsection.</p> <p>(3) Except as specifically provided in the trust instrument, the provisions of this subsection apply to a trust established before or after the effective date of this subsection and to a life insurance policy acquired by the trustee before or after the effective date of this section.</p> <p>(K) This section applies to “charitable remainder trusts”. “Charitable remainder trust” means a trust that provides for a specified distribution at least annually for either life or a term of years to one or more beneficiaries, at least one of which is not a charity with an irrevocable remainder interest to be held for the benefit of, or paid over to, charity.</p> <p>(L) This section must be applied and construed to effectuate its general purpose to make uniform the law with respect to the subject of this section among the States enacting it.</p>	<p>remains a proper investment;</p> <p>(b) exercise policy options available under the contract; or</p> <p>(c) diversify the contract.</p> <p>(2) The trustee is not liable to the beneficiaries of the contract of insurance or to another party for loss arising from this subsection.</p> <p>(3) Except as specifically provided in the trust instrument, the provisions of this subsection apply to a trust established before or after the effective date of this subsection and to a life insurance policy acquired by the trustee before or after the effective date of this section <u>act</u>.</p> <p>(K) This section <u>act</u> applies to ‘charitable remainder trusts’. ‘Charitable remainder trust’ means a trust that provides for a specified distribution at least annually for either life or a term of years to one or more beneficiaries, at least one of which is not a charity with an irrevocable remainder interest to be held for the benefit of, or paid over to, charity.</p> <p>(L) This section <u>act</u> must be applied and construed to effectuate its general purpose to make uniform the law with respect to the subject of this section <u>act</u> among the States enacting it.</p> <p>REPORTER’S COMMENT</p> <p>Subsection 62-7-933(B):</p> <p>Subsection 62-7-933(B)(1) of the South Carolina Uniform Prudent Investor Act (SCUPIA) imposes on trustees the obligation of prudence in the conduct of investment functions and identifies further subsections of SCUPIA that specify the attributes of prudent conduct.</p> <p>Origins. The prudence standard for trust investing traces back to <i>Harvard College v. Amory</i>, 26 Mass. (9 Pick.) 446 (1830). Trustees should “observe how men of prudence, discretion and intelligence manage <i>their own affairs</i>, not in regard to speculation, but in regard to the permanent disposition of <i>their funds</i>, considering the probable income, as well as the probable safety of the capital to be</p>
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invested.” Id. at 461.

Prior legislation. The Model Prudent Man Rule Statute (1942), sponsored by the American Bankers Association, undertook to codify the language of the *Amory* case. See Mayo A. Shattuck, *The Development of the Prudent Man Rule for Fiduciary Investment in the United States in the Twentieth Century*, 12 *Ohio State L.J.* 491, at 501 (1951); for the text of the model act, which inspired many state statutes, see id. at 508-09. Another prominent codification of the *Amory* standard is Uniform Probate Code § 7-302 (1969), which provides that “the trustee shall observe the standards in dealing with the trust assets that would be observed by a prudent man dealing with *the property of another ...*” [Italics added.]

Congress has imposed a comparable prudence standard for the administration of pension and employee benefit trusts in the Employee Retirement Income Security Act (ERISA), enacted in 1974. ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a), provides that “a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and . . . with the care, skill, prudence, and diligence under the circumstances then prevailing that *a prudent man acting in a like capacity and familiar with such matters* would use in the *conduct of an enterprise of like character and with like aims . . .*” [Italics added.]

Prior Restatement. The Restatement of Trusts 2d (1959) also tracked the language of the *Amory* case: “In making investments of trust funds the trustee is under a duty to the beneficiary ... to make such investments and only such investments as a prudent man would make of his own property having in view the preservation of the estate and the amount and regularity of the income to be derived” Restatement of Trusts 2d § 227 (1959).

Objective standard. The concept of prudence in the judicial opinions and legislation is essentially relational or comparative. It resembles in this respect the “reasonable

person” rule of tort law. A prudent trustee behaves as other trustees similarly situated would behave. The standard is, therefore, objective rather than subjective. SCUPIA subsections 62-7-933(C) through (G) identify the main factors that bear on prudent investment behavior.

Variation. Almost all of the rules of trust law are default rules, that is, rules that the settlor may alter or abrogate. SCUPIA subsection 62-7-933(B)(2) carries forward this traditional attribute of trust law. Traditional trust law also allows the beneficiaries of the trust to excuse its performance, when they are all capable and not misinformed. Restatement of Trusts 2d § 216 (1959).

Subsection 62-7-933(C)

SCUPIA subsection (C) is the heart of the Act. Subsections (C)(1), (2) and (3) are patterned loosely on the language of the Restatement of Trusts 3d: Prudent Investor Rule § 227 (1992), and on the 1991 Illinois statute, 760 § ILCS 5/5a (1992). Subsection (C)(6) is derived from Uniform Probate Code § 7-302 (1969).

Objective Standard. SCUPIA subsection (C)(1) carries forward the relational and objective standard made familiar in the *Amory* case, in earlier prudent investor legislation, and in the Restatements. Early formulations of the prudent person rule were sometimes troubled by the effort to distinguish between the standard of a prudent person investing for another and investing on his or her own account. The language of SCUPIA subsection (C)(1), by relating the trustee’s duty to “the purposes, terms, distribution requirements, and other circumstances of the trust,” should put such questions to rest. The standard is the standard of the prudent investor similarly situated.

Portfolio Standard. SCUPIA subsection (C)(2) emphasizes the consolidated portfolio standard for evaluating investment decisions. An investment that might be imprudent standing alone can become prudent if undertaken in sensible relation to other trust assets, or to other

nontrust assets. In the trust setting the term “portfolio” embraces the entire trust estate.

Risk and Return. SCUPIA subsection (C)(2) also sounds the main theme of modern investment practice, sensitivity to the risk/return curve. See generally the works cited in the Prefatory Note to this Act, under “Literature.” Returns correlate strongly with risk, but tolerance for risk varies greatly with the financial and other circumstances of the investor, or in the case of a trust, with the purposes of the trust and the relevant circumstances of the beneficiaries. A trust whose main purpose is to support an elderly widow of modest means will have a lower risk tolerance than a trust to accumulate for a young scion of great wealth.

SCUPIA subsection (C)(2) of this Act follows Restatement of Trusts 3d: Prudent Investor Rule § 227(a), which provides that the standard of prudent investing “requires the exercise of reasonable care, skill, and caution, and is to be applied to investments not in isolation but in the context of the trust portfolio and as a part of an overall investment strategy, which should incorporate risk and return objectives reasonably suitable to the trust.”

Factors Affecting Investment. SCUPIA subsection (C)(3) points to certain of the factors that commonly bear on risk/return preferences in fiduciary investing. This listing is *non-exclusive*. Tax considerations, such as preserving the stepped up basis on death under Internal Revenue Code § 1014 for low-basis assets, have traditionally been exceptionally important in estate planning for affluent persons. Under the present recognition rules of the federal income tax, taxable investors, including trust beneficiaries, are in general best served by an investment strategy that minimizes the taxation incident to portfolio turnover. See generally Robert H. Jeffrey & Robert D. Arnott, *Is Your Alpha Big Enough to Cover Its Taxes?*, *Journal of Portfolio Management* 15 (Spring 1993).

Another familiar example of how tax

considerations bear upon trust investing: In a regime of pass-through taxation, it may be prudent for the trust to buy lower yielding tax-exempt securities for high-bracket taxpayers, whereas it would ordinarily be imprudent for the trustees of a charitable trust, whose income is tax exempt, to accept the lowered yields associated with tax-exempt securities.

When tax considerations affect beneficiaries differently, the trustee's duty of impartiality requires attention to the competing interests of each of them.

Duty to Monitor. SCUPIA subsection (C)(1) through (4) apply both to investing and managing trust assets. "Managing" embraces monitoring, that is, the trustee's continuing responsibility for oversight of the suitability of investments already made as well as the trustee's decisions respecting new investments.

Duty to Investigate. SCUPIA subsection (C)(4) carries forward the traditional responsibility of the fiduciary investor to examine information likely to bear importantly on the value or the security of an investment - for example, audit reports or records of title. E.g., *Estate of Collins*, 72 Cal. App. 3d 663, 139 Cal. Rptr. 644 (1977) (trustees lent on a junior mortgage on unimproved real estate, failed to have land appraised, and accepted an unaudited financial statement; held liable for losses).

Abrogating Categorical Restrictions. SCUPIA subsection (C)(5)(a) clarifies that no particular kind of property or type of investment is inherently imprudent. Traditional trust law was encumbered with a variety of categorical exclusions, such as prohibitions on junior mortgages or new ventures. In some states legislation created so-called "legal lists" of approved trust investments. The universe of investment products changes incessantly. Investments that were at one time thought too risky, such as equities, or more recently, futures, are now used in fiduciary portfolios. By contrast, the investment that was at one time thought ideal for trusts, the long-term bond, has

been discovered to import a level of risk and volatility - in this case, inflation risk - that had not been anticipated. Accordingly, SCUPIA subsection (C)(5)(a) follows Restatement of Trusts 3d: Prudent Investor Rule in abrogating categoric restrictions. The Restatement says: “Specific investments or techniques are not *per se* prudent or imprudent. The riskiness of a specific property, and thus the propriety of its inclusion in the trust estate, is not judged in the abstract but in terms of its anticipated effect on the particular trust’s portfolio.” Restatement of Trusts 3d: Prudent Investor Rule § 227, Comment f, at 24 (1992). The premise of SCUPIA subsection (C)(5)(a) is that trust beneficiaries are better protected by the Act’s emphasis on close attention to risk/return objectives as prescribed in SCUPIA subsection (C)(2) than in attempts to identify categories of investment that are *per se* prudent or imprudent.

The Act impliedly disavows the emphasis in older law on avoiding “speculative” or “risky” investments. Low levels of risk may be appropriate in some trust settings but inappropriate in others. It is the trustee’s task to invest at a risk level that is suitable to the purposes of the trust.

Professional Fiduciaries.

The ULC Drafting Committee declined the suggestion that the Uniform Prudent Investor Act (UPIA) should create an exception to the prudent investor rule (or to the diversification requirement of UPIA Section 3) in the case of smaller trusts. The Committee believes that UPIA subsections 2(b) and (c) (SCUPIA subsections (C)(2) and (3) emphasize factors that are sensitive to the traits of small trusts. Furthermore, it is always open to the settlor of a trust under UPIA subsection 1 (b) (SCUPIA subsection (B)(2)) to reduce the trustee’s standard of care if the settlor deems such a step appropriate. The official comments to the 1992 Restatement observe that pooled investments, such as mutual funds and bank common trust funds, are especially suitable for small trusts. Restatement of Trusts 3d: Prudent Investor Rule

§ 227, Comments *h, m*, at 28, 51; reporter's note to Comment *g*, *id.* at 83.

Matters of Proof. Although virtually all express trusts are created by written instrument, oral trusts are known, and accordingly, this Act presupposes no formal requirement that trust terms be in writing. When there is a written trust instrument, modern authority strongly favors allowing evidence extrinsic to the instrument to be consulted for the purpose of ascertaining the settlor's intent. See Uniform Probate Code Sec. 2-601 (1990), Comment; Restatement (Third) of Property: Donative Transfers (Preliminary Draft No. 2, ch. 11, Sept. 11, 1992).

Subsection 62-7-933(D)

The language of this SCUPIA subsection derives from Restatement of Trusts 2d § 228 (1959). ERISA insists upon a comparable rule for pension trusts. ERISA § 404(a)(1)(C), 29 U.S.C. § 1104(a)(1)(C). Case law overwhelmingly supports the duty to diversify. See Annot., *Duty of Trustee to Diversify Investments, and Liability for Failure to Do So*, 24 A.L.R. 3d 730 (1969) & 1992 Supp. at 78-79.

The 1992 Restatement of Trusts takes the significant step of integrating the diversification requirement into the concept of prudent investing. Section 227(b) of the 1992 Restatement treats diversification as one of the fundamental elements of prudent investing, replacing the separate section 228 of the Restatement of Trusts 2d. The message of the 1992 Restatement, carried forward in SCUPIA subsection (D) is that prudent investing ordinarily requires diversification.

Circumstances can, however, overcome the duty to diversify. For example, if a tax-sensitive trust owns an under-diversified block of low-basis securities, the tax costs of recognizing the gain may outweigh the advantages of diversifying the holding. The wish to retain a family business is another situation in which the purposes of the trust sometimes override the conventional duty to diversify.

Rationale for Diversification. "Diversification

reduces risk . . . [because] stock price movements are not uniform. They are imperfectly correlated. This means that if one holds a well diversified portfolio, the gains in one investment will cancel out the losses in another.” Jonathan R. Macey, *An Introduction to Modern Financial Theory* 20 (American College of Trust and Estate Counsel Foundation, 1991). For example, during the Arab oil embargo of 1973, international oil stocks suffered declines, but the shares of domestic oil producers and coal companies benefitted. Holding a broad enough portfolio allowed the investor to set off, to some extent, the losses associated with the embargo.

Modern portfolio theory divides risk into the categories of “compensated” and “uncompensated” risk. The risk of owning shares in a mature and well-managed company in a settled industry is less than the risk of owning shares in a start-up high-technology venture. The investor requires a higher expected return to induce the investor to bear the greater risk of disappointment associated with the start-up firm. This is compensated risk - the firm pays the investor for bearing the risk. By contrast, nobody pays the investor for owning too few stocks. The investor who owned only international oils in 1973 was running a risk that could have been reduced by having configured the portfolio differently - to include investments in different industries. This is uncompensated risk - nobody pays the investor for owning shares in too few industries and too few companies. Risk that can be eliminated by adding different stocks (or bonds) is uncompensated risk. The object of diversification is to minimize this uncompensated risk of having too few investments. “As long as stock prices do not move exactly together, the risk of a diversified portfolio will be less than the average risk of the separate holdings.” R.A. Brealey, *An Introduction to Risk and Return from Common Stocks* 103 (2d ed. 1983).

There is no automatic rule for identifying how

much diversification is enough. The 1992 Restatement says: “Significant diversification advantages can be achieved with a small number of well-selected securities representing different industries Broader diversification is usually to be preferred in trust investing,” and pooled investment vehicles “make thorough diversification practical for most trustees.” Restatement of Trusts 3d: Prudent Investor Rule § 227, General Note on Comments *e-h*, at 77 (1992). See also Macey, *supra*, at 23-24; Brealey, *supra*, at 111-13.

Diversifying by Pooling. It is difficult for a small trust fund to diversify thoroughly by constructing its own portfolio of individually selected investments. Transaction costs such as the round-lot (100 shares) trading economies make it relatively expensive for a small investor to assemble a broad enough portfolio to minimize uncompensated risk. For this reason, pooled investment vehicles have become the main mechanism for facilitating diversification for the investment needs of smaller trusts.

Most states have legislation authorizing common trust funds; see 3 Austin W. Scott & William F. Fratcher, *The Law of Trusts* § 227.9, at 463-65 n.26 (4th ed. 1988) (collecting citations to state statutes). As of 1992, 35 states and the District of Columbia had enacted the Uniform Common Trust Fund Act (UCTFA) (1938), overcoming the rule against commingling trust assets and expressly enabling banks and trust companies to establish common trust funds. 7 Uniform Laws Ann. 1992 Supp. at 130 (schedule of adopting states). The Prefatory Note to the UCTFA explains: “The purposes of such a common or joint investment fund are to diversify the investment of the several trusts and thus spread the risk of loss, and to make it easy to invest any amount of trust funds quickly and with a small amount of trouble.” 7 Uniform Laws Ann. 402 (1985).

Fiduciary Investing in Mutual Funds. Trusts can also achieve diversification by investing in mutual funds. See Restatement of Trusts 3d: Prudent Investor Rule, § 227, Comment *m*, at

99-100 (1992) (endorsing trust investment in mutual funds). ERISA § 401(b)(1), 29 U.S.C. § 1101(b)(1), expressly authorizes pension trusts to invest in mutual funds, identified as securities “issued by an investment company registered under the Investment Company Act of 1940”

Subsection 62-7-933(E)

SCUPIA subsection (E), requiring the trustee to dispose of unsuitable assets within a reasonable time, is old law, codified in Restatement of Trusts 3d: Prudent Investor Rule § 229 (1992), lightly revising Restatement of Trusts 2d § 230 (1959). The duty extends as well to investments that were proper when purchased but subsequently become improper. Restatement of Trusts 2d § 231 (1959). The same standards apply to successor trustees, see Restatement of Trusts 2d § 196 (1959).

The question of what period of time is reasonable turns on the totality of factors affecting the asset and the trust. The 1959 Restatement took the view that “ordinarily any time within a year is reasonable, but under some circumstances a year may be too long a time and under other circumstances a trustee is not liable although he fails to effect the conversion for more than a year.” Restatement of Trusts 2d § 230, comment *b* (1959). *The 1992 Restatement retreated from this rule of thumb, saying, “No positive rule can be stated with respect to what constitutes a reasonable time for the sale or exchange of securities.”* Restatement of Trusts 3d: Prudent Investor Rule § 229, comment *b* (1992).

The criteria and circumstances identified in SCUPIA subsection (C)(3) as bearing upon the prudence of decisions to invest and manage trust assets *also pertain to the prudence of decisions to retain or dispose of inception assets under this section.*

Subsection 62-7-933(G)

This subsection derives from the 1991 Illinois act, 760 ILCS 5/5(a)(2) (1992), which draws upon Restatement of Trusts 3d: Prudent Investor Rule § 227, comment *b*, at 11 (1992). Trustees

	<p>are not insurers. Not every investment or management decision will turn out in the light of hindsight to have been successful. Hindsight is not the relevant standard. In the language of law and economics, the standard is ex ante, not ex post.</p> <p>Subsection 62-7-933(I):</p> <p>This provision meant to facilitate incorporation of the Act by means of the formulaic language commonly used in trust instruments.</p>
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