

FIDUCIARY LITIGATION AND THE UPIA TWINS

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Fiduciary Litigation and the UPIA Twins

Presented By Alvin J. Golden and Sarah Patel Pacheco

- I. **INTRODUCTION.** On January 1, 2004, the Texas versions of the Uniform Principal and Income Act (Texas Probate Code Ann. Chapter 116) and the Uniform Prudent Investor Act (Texas Probate Code Chapter 117) became the law of Texas. The Uniform Principal and Income Act (“UPAIA”) has been adopted in 39 states and the U. S. Virgin Islands, and the Uniform Prudent Investor Act (“UPIA”) has been adopted in 41 states, the District of Columbia and the U.S. Virgin Islands. Both Acts represent a sea change in the law of trusts in this state. They are sometimes collectively referred to as the “Acts”. UPAIA is designed to allow changes in accounting required by the investment changes dictated by UPIA. It is important to remember that these Acts are default rules, which may be overridden by the terms of the instrument, and are designed to work together.
- II. **SCOPE.** This paper will explore how the UPIA Twins have altered the face of fiduciary litigation in Texas by analyzing selected provisions of the Uniform Acts (as adopted by Texas). These Acts change the way trusts are drafted and administered, and alter the potential liabilities of fiduciaries, by imposing new duties and responsibilities *by statute* on trustees, which formerly existed under the common law .
- III. **PRINCIPAL CHANGES (NO PUN INTENDED).** There are several changes wrought by these Acts that require a change in attitude by estate planners, trustees, and those who become involved in fiduciary litigation. In an attempt to aid in interpreting the Acts, the Real Estate Probate and Trust Law Section of the Bar (with the invaluable assistance of Professor Stanley M. Johanson) was able to persuade West to publish the Comments of the National Conference of Commissioners on Uniform State Laws and the comments of the Real Estate, Probate and Trust Law Section (the “Section”) where the Bar made changes or where peculiarities of Texas law required explanation beyond the Uniform Laws Comments. These Comments are *usually* helpful in interpreting the statute. They are somewhat like Revenue Rulings in that they have no force of law, but may aid practitioners, trustees and the courts in applying these new laws uniformly.
- A. **UPIA.** Although UPIA’s dictate that the Trustee invest for overall return in keeping with Modern Portfolio Theory¹ is probably its central change, it is important to note that UPIA implements that dictate by requiring the trustee to focus on the terms and purposes of *the* specific trust being administered rather than on a list of approved trust investments.

¹For a discussion of Modern Portfolio Theory, *see* Golden, “Total Return Unitrusts; Is this a Solution in Search of a Problem,” 28 ACTEC Journal 121 (Fall, 2002)

1. Application. UPIA applies *only* to trusts and it applies to trusts existing on January 1, 2004 and those created thereafter. Thus it applies to all trusts, but only to the extent of acts or decisions after the effective date.
2. Fundamental Changes. The Uniform Act Prefatory Note lists five fundamental changes made by UPIA.
 - a. Standard of prudence is applied to any investment as part of the overall portfolio, rather than to individual investments. This represents a change to the common law which determined whether a trustee had breached his duty of prudence on an asset by asset basis.² Texas Trust Code §117.004(b)
 - b. Tradeoff in all investing between risk and return is identified as the trustee's central consideration. Texas Trust Code §117.004(b).
 - c. Trustee may invest in anything that meets risk/return objectives and the other elements of prudence. There are no prohibited investments. Thus, as part of a portfolio, a trustee may invest in derivatives, hedge funds, and other investments which might have been prohibited before. Texas Trust Code §117.004(e).
 - d. Diversification has been integrated into prudent investing and is central to the risk/return balance. Texas Trust Code §117.005.
 - e. Delegation of trustee investment and management functions is now permitted, with certain safeguards. Texas has departed from the uniform act and has strengthened the safeguards. Texas Trust Code § 117.011.
3. About Process. Because investment for overall return for any particular trust is extremely subjective, UPIA is more about process than results.

B. UPAIA. According to the Uniform Act Prefatory Note, UPAIA "deals conservatively with the tension between modern investment theory and traditional income allocation."

1. Application. UPAIA applies to both trusts and estates (with a key exception noted below). (A summary of the allocation provisions of UPAIA is contained in the Appendix.) As with UPIA, it applies to trusts existing on January 1, 2004, and estates still under administration at that date, and to trusts created and administrations opened after such date. It only applies to acts or decisions after the effective date.³

²Texas law apparently already had the "total portfolio test" in determining prudence. Texas Trust Code §113.056(a) contained the following provision prior to its repeal: "In determining whether a trustee has exercised prudence with respect to an investment decision, such determination shall be made taking into consideration the investments of all the assets of the trust...over which the trustee had management and control, rather than a consideration as to the prudence of the single investment of the trust..."

³Texas Probate Code Ann. §378B, which governed allocations between income and principal was not repealed *in toto*, but defers to Texas Trust Code Chapter 116.

2. Power to Adjust. The centerpiece of UPIA is the power to adjust discussed in detail below. Texas Trust Code §116.005. This allows the trustee to adjust distributions so that the trustee may invest for overall return and still fulfill its duty of impartiality (now codified as a fiduciary duty) between the income beneficiary and the remainder beneficiary. A detailed section deals with the liability of a trustee for exercising or not exercising the power to adjust, and here again Texas departs from the Uniform Act. Texas Trust Code §116.006.
3. Other Texas Departures. Texas also departs from the Uniform Act with respect to oil and gas (Texas Trust Code §116.174) and retirement plan distributions (Texas Trust Code §116.172).

IV. **INVESTMENT STANDARDS**. UPIA lays out investment standards for trustees and the Texas Probate Code sets out investment standards for executors. As will be seen below, the standards are very different because the purpose of each fiduciary is different.

A. TRUSTEE. The trustee is directed to invest "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." Texas Trust Code §117.004(a). (Emphasis added.) The trustee's investment horizon is, in most cases, long term, and usually must take into account more than one generation of beneficiaries.

1. Circumstances to Be Considered.⁴ Texas Trust Code § 117.004(c) mandates that "among circumstances" to be considered by a trustee "are such of the following *as* are relevant to the trust or to its beneficiaries" (emphasis added):
 - a. general economic conditions;
 - b. possible effects of inflation or deflation;
 - c. expected tax consequences of investment decisions or strategies;
 - d. the role that each investment (*e.g.*, closely held business, personal property, real estate, minerals) or course of action plays within the overall trust portfolio;
 - e. expected total return from income and appreciation of capital;
 - f. other resources of the beneficiary;

⁴These are strikingly similar to those contained in Texas Trust Code §116.005, dealing with the power to adjust.

- g. needs for liquidity, regularity of income, and preservation or appreciation of capital; and
- h. an asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.

As an illustration of the difficulties inherent in this kind of decision making, it has been suggested that the duty to diversify is different depending upon the identity of the income beneficiary. If the income beneficiary is elderly and in need of steady income, should the trustee adopt an investment program that produces a steady stream of income rather than the maximum overall return? Does it depend on whether the power to adjust is available?

2. Matter of Process and Standard of Liability. As noted earlier, UPIA is all about the *process* of the decision making by the trustee. It is impossible to construct a universal decision matrix: First, the list in Texas Trust Code §117.004(c) is clearly *not* exclusive ("among circumstances"). Second, not all of the listed considerations will be relevant in every trust. Thus, one would expect that different trustees in the same set of circumstances would arrive at what may be very different decisions and investments.
 - a. How is a trier of fact to determine whether a trustee has properly exercised prudence in making investments when the investments do not perform to the satisfaction of one or more beneficiaries? The answer should be that the judge or jury should not consider the results of the investments, nor should it consider whether it would have invested differently. Rather, it should consider whether the trustee failed to exercise its discretion properly in determining the factors to be considered as relevant to the trust, and the application of those factors to the trust.
 - b. The trustee's compliance "is determined in light of the facts and circumstances existing at the time of the trustee's decision or action, *and not by hindsight.*" (Emphasis added.) Texas Trust Code §117.010.
 - c. A trustee who has "special skills or expertise, or is named trustee in reliance on the trustee's representation that the trustee has special skills or expertise, has a duty to use those special skills or expertise." Texas Trust Code §117.004(f). Thus a professional trustee is held to a higher standard than an individual trustee.
3. Diversification. Texas Trust Code §117.005 requires the trustee to diversify

investments “unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying.” What kind of assets would justify a trustee in failing to diversify? It depends on the trust and the specific circumstances. For example, an interest in a closely held business or a family farm or ranch could be assets which should not be sold to achieve diversification. The draftsman should explore with the testator or settlor whether he or she wishes the duty to diversify to be waived based upon the creator’s desire and knowledge of the assets to be held in the trust.

4. Duties at Inception. In a 180° departure from prior Texas law, Texas Trust Code § 117.006 mandates that a trustee “within a reasonable time after accepting the trusteeship or receiving trust assets” review the assets in the trust and determine whether or to what extent the assets received are appropriate to retain considering the “purposes, terms, distribution requirements and other circumstances of the trust, and the requirements of this chapter.” Of course, one key question is what is a reasonable time. While some commentators have speculated that one year maybe reasonable, it is more likely that it depends on circumstances, and that in many cases a reasonable time may be substantially shorter. This duty, of course, is part and parcel of the duty to diversify.
5. Impartiality. Texas Trust Code §117.008 requires the trustee to act impartially among beneficiaries in investing and managing the trust assets. This duty has not been previously codified in Texas. While this duty is not *per se* an investment standard, it certainly affects the asset mix.

B. LITIGATION CONSIDERATIONS AS TO TRUSTEES.

1. Individual Trustees. These standards impose a real challenge for individual trustees. While professional trustees are probably held to a higher standard, individuals are faced with the daunting task of understanding overall investment philosophy.
 - a. Process. Institutional trustees by now *should* have developed a process for applying prudent investor standards to its investments, it will be virtually impossible for an individual to demonstrate that he or she considered all of the criteria set out in the Act, much less all of the criteria relevant to *the* trust.
 - b. Diversification. How can any individual trustee hope to understand the very complex financial markets that exist today. Is it almost a breach of trust to fail to delegate or employ a financial advisor (or a series of financial advisors)?
 - c. Duties at Inception. An organized process is not necessary for this

examination, but the trustee must show that the trustee reviewed the assets received and made a determination as to whether to retain them. This is particularly difficult if the trust contains special assets – stock in the closely held family business or the family ranch or plan.

2. Institutional Trustees. How does the higher standard to which an institutional trustee is held affect its liability?
 - a. Process.. Each institutional trustee should have developed and formalized procedures for establishing investment criteria for each trust. Beneficiary’s counsel should discover the manual as well as any minutes of the committee dealing with the process for determining investment allocations for the trust. What is their policy as to how often do these allocations need to be reviewed? And, do they document following them.
 - b. Diversification. Even the most sophisticated institutional investors may not have access to all the investments which may be appropriate in any given situation. They too may need to employ specialists or delegate.
 - c. Assets at Inception. An institutional trustee should have procedures for this review also.
3. Impartiality. This duty, which has always existed, is now codified. While the trustee is directed to invest for overall return, the trustee still must be mindful of the interests of the interests of the different classes of beneficiaries. For example, the trustee cannot invest solely in equities and rely on the power to adjust to provide sufficient income for the income beneficiary.

C. EXECUTOR OR ADMINISTRATOR. Unlike the trustee, the personal representative of a decedent’s estate (the “PR”) is not subject to the prudent investor standard and is in office for a finite amount of time. In larger estates, this period may be extended, but in many estates, the PR serves for two years or less. Additionally, the PR looks only to the current beneficiaries of the estate.

1. Prudence. The PR’s duty of prudence is set out in Texas Probate Code Ann. §230. The PR is directed to “take care of the property of the estate of his testator or intestate as a prudent man would take of his own property...” Note that this is even less precise than the common law prudent man rule or the Texas version of the prudent

man rule.⁵

2. Caretaker. The PR is really more a caretaker charged with conserving the assets, and to some extent with maintaining the assets themselves so that the beneficiaries inherit what the decedent owned at death. However, this does not allow a PR to hold on to an asset just because it was in the estate if prudence dictates that such asset be disposed of (*e.g.*, Enron stock or an offer for an asset from a third party which is well above market value). Great tension exists between the desire to maintain the asset and exercising prudence in its disposition.

V. **POWER TO ADJUST**. The “power to adjust” is set forth in Texas Trust Code §116.005 and is the necessary power to allow the trustee to invest for total return. This power is not available to a PR. This power, simply stated, is the power to convert principal to income and *vice-versa*. It is generally accepted that the power to convert principal to income is not limited to principal receipts of the current year, but may also include unrealized gains.

A. PURPOSE OF THE POWER TO ADJUST. Since the trustee is mandated under UPIA to invest for overall return, the trustee must be given some method of treating the beneficiaries impartially if the investments are skewed in one direction. That method is the power to adjust distributions so that the income beneficiary receives a fair return from the trust, while the remainder beneficiary can be assured of some protection of principal.

1. Historical Perspective. While the power to adjust is statutorily new, trustees have historically exercised this power from a different perspective. Before UPIA mandated investing for overall return, the trustee would adjust its investment policy to produce what was hopefully a reasonable amount of income. In other words, the trustee would “adjust” between income and principal by investing to produce the desired amount of income.

2. Same Power, Different Approach. After the adoption of the power to adjust contained in UPAIA, the trustee is free to follow UPIA and invest for optimum results and simply recharacterize the components of the trust to produce a fair result for all beneficiaries. In other words, rather than affecting income by investment policy, the trustee now ignores income in investing and determines income by the power to adjust.

B. REQUIREMENTS TO EXERCISE POWER TO ADJUST. Texas Trust Code §116.005(a)

⁵Prior to its partial repeal, Texas Trust Code §113.056(a) required a trustee to “exercise the judgment and care under the circumstances then prevailing that persons of ordinary 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 from *as well as the probable increase in value and* the safety of their capital.” (The italicized portion was not part of the common law prudent man standard.)

lays out the conditions precedent to the trustee's exercise of the power to adjust to the extent the trustee deems necessary if:

- a. The trustee invests and manages the trust assets as a prudent investor;
- b. 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
- c. The trustee determines that it is unable to administer the trust impartially based upon what is fair and reasonable to all the beneficiaries unless the document directs otherwise. Texas Trust Code §116.004(b), which also states that a "determination in accordance with this chapter is presumed to be fair and reasonable to all the beneficiaries."
- d. This power to adjust includes the power to allocate all or part of a capital gain to trust income.

C. CONSIDERATIONS IN EXERCISING THE POWER TO ADJUST. The trustee is directed to consider "*all* factors relevant to the trust and its beneficiaries, *including* the following factors to the extent they are relevant." (Emphasis added.) Note that the trustee is not required even to consider all of the listed factors, and must consider other factors to the extent they are relevant, whatever that means. As with the investments, the decision concerning the power to adjust is more about process than result. The listed factors are:

- a. The nature, extent and duration of the trust;
- b. The intent of the settlor (obviously only to the extent it can be ascertained, but the trustee, unlike the court, should be allowed to go outside the four corners of the document in certain cases);
- c. The identity and circumstance of beneficiaries;
- d. Need for liquidity, regularity of income, and preservation and appreciation of capital;
- e. The nature of the assets in the trust and, somewhat strangely in light of the trustee's duty to evaluate the assets received, whether the asset was purchased by the trustee or received from the settlor;
- f. The net amount allocated to income under other provisions of this chapter and the increase or decrease in the principal value of the assets, which the trustee may estimate if market values are not readily available;

- g. whether and to what extent the terms of the trust contain the power to invade principal or accumulate income or prohibit the trustee from invading income or accumulating principal and the extent to which the trustee has from time to time exercised such powers;
- h. the actual and *anticipated* effect of economic conditions and effects of inflation and deflation; and,
- i. the anticipated tax consequences of an adjustment.

D. HOW THE POWER MIGHT BE EXERCISED. Initially it was thought that the trustee would probably see how much income was actually realized and then adjust at the end of the year. The impracticalities of this approach soon became evident, and the trust industry determined that it would exercise the power to adjust by using a unitrust approach; *i.e.*, distributions would be made based upon a percentage of the value of the trust, determined at the beginning of the year so that the beneficiaries would be able to plan on distributions. (For a further discussion of unitrusts, see below.) The trustee should review this policy at reasonable intervals, and change the percentage or go to a different form of adjustment when circumstances dictate.

E. LITIGATION CONSIDERATIONS IN EXERCISE. As a general proposition, Texas law does not allow a court to substitute its discretion for that of the trustee, unless the trustee has abused or failed to exercise its discretion. *Lesikar v. Moon*, 237 S.W. 3d 361 (Tex App. – Houston [14th Dist.] 2007).

1. Process. Does Trustee have that power (see below), and, if so, did the Trustee go through the relevant considerations and did the trustee document the process.
2. Is There a Minimum amount of Income? Because Texas has adopted a statute allowing unitrusts which pay between 3% and 5%, a school of thought is developing that the power to adjust must be exercised to produce at least a 3% return to the income beneficiary. The Texas statute (and those in several other states) are based in turn upon the regulations under IRC §643, which deal with qualification for the marital deduction and have nothing at all to do with the fiduciary duty of impartiality. Thus, the trustee should not be liable for failing to distribute at least 3% income, nor should a distribution of 3%-5% be a safe harbor.

F. CIRCUMSTANCES IN WHICH ADJUSTMENT PROHIBITED. Texas Trust Code §116.005(c) lists those circumstances in which the power to adjust may not be available to one or more of the trustees. Almost all of the prohibitions are tax driven and designed to avoid loss of the marital deduction, gift tax issues, or estate inclusion issues. Some of the

more important and/or controversial are discussed below.

1. Trustee as Beneficiary. Texas Trust Code §116.005(c)(6) prohibits a trustee-beneficiary from exercising the power to adjust. This restriction, again tax driven, is designed to prevent the trustee from being treated as having a general power of appointment and thus causing both income and estate tax problems. There is also, of course, the fiduciary duty problem of a trustee using his office to benefit himself.
2. Trustee not a Beneficiary. Texas Trust Code §116.005(c)(7) prohibits a trustee from exercising the power to adjust, even though not a beneficiary, if the exercise would benefit the trustee, directly or indirectly. This is an extension of subsection (c)(7).
3. Exercise by Co-Trustee. If there is a disinterested co-trustee, then restrictions on the ability of a trustee to exercise the power to adjust contained in subsections (c)(5) through (c)(7) do not apply to the independent co-trustee.
4. Restriction in Instrument Not a Bar. Texas Trust Code §116.005(f) states that terms of a trust that limit the power of a trustee to make adjustments between principal and income will not affect the power to adjust unless it is clear from the instrument that the settlor intended to restrict the power to adjust. For example, a provision in the trust prohibiting invasion of principal would not prevent the exercise of the power to adjust, since that is not an invasion of principal, but merely a determination of income. (But see Example 4 of the Comments discussed below.)

G. OTHER CONSIDERATIONS.

1. When Power to Adjust Is Available. While the power to adjust is probably not necessary in most trusts which permit invasion of principal, it is the nonetheless available. For example, if a trust allows invasion of principal for the support of the beneficiary but requires that the trustee consider other resources available to the beneficiary, no invasion of principal would be available where the beneficiary had more than ample other resources. Yet, the amount of income produced by investing for overall return might be unreasonably low, and an adjustment may be necessary to meet the trustee's duty of impartiality.
2. Example 4. This Example in the comments is very curious in that it suggests that where there is a limitation on the amount of principal to be distributed (in this case 6% of the initial value of the trust over the life of the beneficiary, but only for "dire emergencies"), the trustee may exercise the power to adjust from principal to income only to the extent that a reduction in income resulted from the change to investing for overall return. There is no support in the statutory language for this interpretation unless it is construed as being a "clear" provision meant to deny the trustee the power

to adjust. The facts in Example 4 state that the trust was existing on the effective date of the statute, and was invested in a 50% bond - 50% equity mix. The trustee elected to go to a 90%-10% formulation to achieve overall return and “dividend and interest income” was reduced. [Query how dividend income is reduced if the investment in equities almost doubled.] The example concludes, “Thereafter, even though [the beneficiary] does not experience a dire emergency, T may exercise the power to adjust...to the extent that T determines that the adjustment is from only the capital appreciation resulting from the change in the portfolios asset allocation.” This is an absurd conclusion, and clearly so because it depends on what the allocation was before UPIA.

H. JUDICIAL CONTROL OF DISCRETIONARY POWER. Texas Trust Code §116.006 is based upon a provision added to the Uniform Act in 2000, after corporate trustees expressed concern about potential liability for exercising (or not exercising) the power to adjust. Much of this section is simply a restatement of the common law. The Texas law substantially follows the Uniform Act in subsections (a) through (c), but departs in subsection (d) by denying trustees access to the courts unless there is a *bona fide* probability of controversy. The feeling of the Section was that court approval should not be available where the sole interest of the trustee was assuring that it had a security blanket.

1. Abuse of Discretion. A court may not substitute its judgment for the judgment of the trustee unless the court finds that the trustee abused its discretion. This standard is very difficult and specifically directs a court not to substitute its judgment merely because it would have acted differently than the trustee. Texas Trust Code §116.006(a).
2. Application. This abuse of discretion standard applies not only to the decision itself but to the process used in reaching that decision, illustrating once again that the Uniform Acts are about process. Texas Trust Code §116.006(b).
3. Remedies. If the court determines that the trustee has abused its discretion, it must first attempt to correct that abuse by placing the various beneficiaries in the same position as they would have been had the abuse not occurred *by using the trust funds to achieve that result.* If, for example, the income beneficiary had not received sufficient distributions, then additional distributions are made from the trust. If there were excessive distributions, then the trustee may withhold future distributions or the court may direct the beneficiary to return all or part of the excess distribution. If the abuse cannot be remedied from within the trust or distributions, the trustee may be personally liable. Texas Trust Code §116.006(c).
4. Availability of Instructions. Texas Trust Code §116.006(d) departs dramatically from the Uniform Act. If the trustee “reasonably believes” that any beneficiary will

object to the exercise or non-exercise of the power to adjust in Texas Trust Code §116.005, then the trustee may ask the court to determine whether such exercise or non-exercise would be an abuse of discretion.

- a. Trustee must state in its petition “the basis for its belief that a beneficiary would object,” and the refusal of a beneficiary to sign a release does not, by itself, form such a reasonable basis. The Section felt that many times a beneficiary would refuse to sign a release, but have no intention of suing the trustee.
- b. If the petition is sufficient to inform the beneficiary what the trustee intends to do and why, then the burden of proof is on the challenging beneficiary to show that such action or inaction would constitute a breach of trust.
- c. The trustee advances all costs (including attorney’s fees) from the trust, and the court determines how the fees and expenses should be apportioned at the end of the case. This method was adopted to cure what Frank Ikard calls the “paradox of trust litigation” – that the trustee has the funds with which to defend itself, but the beneficiaries who may be harmed are often unable to fund an action.

I. NON-CHARITABLE UNITRUSTS. A unitrust is a trust in which distributions are measured by the value of the trust assets without regard to income or principal allocations. The current (or “income”) beneficiary receives a fixed percentage of the value of the trust each year.⁶ Many states which enacted UPAIA also enacted a “unitrust conversion” statute, allowing the trustee to modify the trust to change the distribution standard in an existing trust from an all income measure to a unitrust distribution. The argument for this approach was that many trusts allowed only income distributions and did not provide for invasion of principal, and that prevented the trustee from investing for overall return. These statutes vary widely from state to state, and many contain complex notice provisions. The Section felt that (i) there were few trusts drafted in Texas that did not permit principal invasion; (ii) that in many (if not most) of those trusts, the power to adjust could be used to allow principal distributions where necessary; (iii) that the complexity added did not warrant a conversion statute; and (iv) in extreme cases, there was probably a judicial remedy.

1. Texas Permits Unitrusts But Not Conversion. The final regulations under IRC §643 (and related sections) adopt state law as a determinant of what constitutes “income”

⁶Many unitrusts also contain a power in the trustee to invade the trust beyond the unitrust amount if the unitrust amount is insufficient for the health, support or maintenance of the current beneficiary. This kind of provision, in effect, converts the unitrust to a support trust with a minimum required distribution. A discussion of the economics and an analysis of the effect of choosing a unitrust is well beyond the scope of this paper. See, Golden, *supra* at Footnote 1.

for trust accounting purposes and for income, gift, estate tax, and generation skipping transfer tax purposes. Thus, if a draftsman in Texas wanted to use a unitrust, the draftsman would be unable to do so and achieve desired tax results unless state law specifically defined “income” as a unitrust amount.⁷ Texas Trust Code §116.007 now supplies that definition of income.

2. “Ordering” Provision. Unless the terms of the trust direct otherwise, the statute dictates what kind of income makes up the unitrust distribution for federal income tax purposes. Texas Trust Code §116.007(d).

VI. **TEXANIZATION OF UPAIA.** The drafters of the Uniform Principal and Income Act had a definite bias toward the remainder beneficiary, feeling that the preservation of principal ultimately benefitted both the current beneficiary and the remainder beneficiary. While this may be true, the Section felt that it might create great injustice and instability in existing trusts and new trusts which did not override certain income and principal allocations.

A. MINERAL INTERESTS. The Uniform Act treats 10% of the receipts from minerals as income and 90% of the receipts as principal.⁸ For income beneficiaries who had been used to receiving 72-1/2% of the revenues from extracted minerals, this change in approach would represent a dramatic shock.

1. Royalties, etc. The Texas version of UPAIA requires the trustee to allocate receipts from royalties, shut-in-well payments, take-or-pay payments, bonuses or delay rentals “equitably.” Texas Trust Code § 116.174(a)(3). Again, this a discretionary decision.
2. Working Interests. Likewise, the Texas version of the Act requires the trustee to allocate receipts from working interests or other interests not otherwise provided for “equitably.”
3. Safe Harbors. Since the Act applies to existing trusts, the trustee is required to allocate according to this Act, but for interests existing on January 1, 2004, the

⁷The final regulations under IRC §643n provide a safe harbor for unitrusts ranging from 3%-5%, and the Texas statute adopts that range. Parenthetically, although the 3% floor may be justified in assuring that the income beneficiary receives some sort of minimum return to qualify as income, there is no rational basis for a ceiling. Charitable remainder trusts, for example, have a 5% minimum, but no ceiling on distributions to the beneficiary. As noted above, there is some concern that the 3% minimum for a unitrust will be interpreted to be a measure of the minimum amount of income which should be earned or distributed by a trustee. This would imply that a trustee could be liable for earning less or that creditors could reach accumulations in the trust if distributions were less than 3%. While both of these propositions are essentially unsound, the Commissioners on Uniform Laws is concerned enough that it is working on an amendment to the UPAIA to clarify this.

⁸One of the Commissioners argued that 100% of receipts should be allocated to principal since it really was a use of principal.

trustee may additionally continue to use “any lawful manner used by the trustee before January 1, 2004.” Texas Trust Code §116.174(d). Further, a receipt allocated to principal is assumed to be equitable if it is equal in amount to the depletion allowance under the Internal Revenue Code. Texas Trust Code §116.174(e).

4. Allocation of Expenses. Texas Trust Code §116.201(1) instructs the trustee to allocate the trustee’s regular compensation 50% to income. In a trust primarily consisting of oil and gas properties, this may place an unfair burden on the principal account which receives substantially less than 50% of the receipts. Prior Texas law allocated these receipts equitably. Likewise, prior Texas law allocated 100% of accounting expenses and judicial proceedings to income, while the Uniform Act as adopted in Texas allocates those expenses equally between the principal and income accounts.

B. PAYMENTS FROM RETIREMENT PLANS. Prior Texas law treated 5% of the “inventory value” of the plan account as income.⁹ The Uniform Act provides that 90% of each distribution from IRAs or retirement plans should be allocated 90% to principal and 10% to income. This would come as a rude awakening to those beneficiaries who had been receiving 100% of those distributions. Because of that, Texas adopted its own version dealing with payments from retirement plans. Texas Trust Code § 116.172.

1. Dividends, Interest and Equivalent Payments. If any part of a payment is characterized by the payor as interest, dividends, or an equivalent payment, then that portion is treated as income and the balance of the payment is treated as principal. Under current accounting practices of fund sponsors and IRA custodians, this characterization almost never happens. Texas Trust Code §116.172(b).
2. Payments Required to be Made. Although the term, “payments required to be made” is not defined, it most likely means required minimum distributions or substantially equal payments made to avoid the 10% early withdrawal penalty under IRC §72(t). If none of the payment is characterized as interest, dividends, or an equivalent payment, 4% of the value of the account (a “deferred payment right”) is allocated to income and the balance is allocated to principal. Texas Trust Code §116.172(c).
3. Other Payments. Payments other than those defined in subsections (b) and (c) are to be allocated to principal. Texas Trust Code §116.172(g). However, if such payments must be allocated to income to protect the estate tax marital deduction, then it is required to be so allocated. Texas Trust Code §116.172(h).

⁹The Texas Bar Comment stated that this approach was “fairer” than the Uniform Act approach, but that it was “confusing, difficult to apply, and did not adequately take into account changes in the value of the underlying asset.”

- VII. **AUTHORITY TO DELEGATE.** At common law, the trustee had no ability to delegate any of his fiduciary responsibilities. In the modern world of very complex financial structures and investment markets, the ability to delegate some or all investment functions may be a necessity. Additionally, the ability to delegate some management functions, such as mineral properties or timber management, may be very valuable.
- A. PRIOR TEXAS LAW. While the common law did not permit delegation, prior Texas law (now repealed Texas Trust Code § 113.060) did permit delegation of the investment function, but caused the trustee to remain liable unless the trustee met certain strict standards for selection and monitoring of the investment agent, and the investment agent agreed to follow the prudent man standard of the Trust Code and be liable if it failed to do so.
- B. DELEGATION UNDER PRESENT LAW. The Uniform Prudent Investor Act allows the delegation of both investment and management functions, and *relieves the trustee of liability* for the acts and omissions of the agent under certain circumstances.
1. The Uniform Act. Portions of the UPIA were adopted in Texas Trust Code §117.011. The trustee must exercise prudence in selecting and monitoring the agent, and the agent must exercise “reasonable care to comply with the terms of the delegation.” Likewise, the agent, by accepting the delegation, submits to the jurisdiction of the courts of Texas.
 2. Texanization. Texas adopted additional protections for the trust before relieving the trustee of liability for acts or omissions of the agent. The trustee is not relieved of liability if, under Texas Trust Code §117.011(c):
 - a. the agent is an affiliate of the trustee;
 - b. the trustee or a beneficiary is required to arbitrate disputes with the agent under the terms of the delegation; or
 - c. the statute of limitations is shortened under the terms of the delegation.
 3. Reasons for Texanization. The Section felt that the trustee should not be relieved of liability for delegation if the trustee and/or the beneficiary was forced to arbitrate and thus denied access to the courts under what was essentially a contract of adhesion if a major brokerage firm were chosen as the agent. Because of federal rules and law, it was uncertain that a provision of Texas law would override, and thus this approach was chosen. The reasoning behind the statute of limitations restriction is obvious.
- C. DUTY TO DELEGATE? With the power to delegate, is there now a duty to delegate? Can

an unsophisticated individual trustee continue to manage a substantial trust without seeking help in the investment function? And would not that trustee be better off delegating and relieving itself of responsibility, rather than just using an agent for advice? In the case of a corporate trustee, there may be market segments in which that trustee has no in house expertise (*e.g.*, hedge funds, other derivatives), and in which it would be appropriate for a portion of the trust to be invested. Does the trustee have to seek out an agent to whom to delegate that function, especially in light of the higher standard of liability for a professional trustee? Of course, if the trustee can employ investment advisors if it is not concerned about relief from liability. And indeed may have a duty to do so if it cannot find an investment manager which meets the requirements of the Texas delegation statute.

VIII. **CONCLUSION.** The foregoing discussion of the theory behind the adoption of the Uniform Acts and select provisions of the Uniform Acts, is but a glimpse into the issues which are presently perceived and some few issues which may exist in the future. Even in those states which have had the Uniform Acts since shortly after their promulgation, they have not been around long enough to allow the mature reflection necessary to fully appreciate their complexity and nuances. Only time can provide that.

**APPENDIX SUMMARIZING UNIFORM
PRINCIPAL AND INCOME ACT PROVISIONS**

A. APPLICABILITY STANDARDS (Texas Trust Code §116.004):

Generally provides that when allocating receipts and disbursements to or between principal and income, a fiduciary¹⁰:

1. shall administer a trust or estate in accordance with the Texas Trust Code unless the terms of the trust or will contain a different provision or do not give the fiduciary a discretionary power of administration in which case the fiduciary shall allocate in the manner provided in the trust or will;
2. shall add a receipt or charge a disbursement to principal to the extent that the terms of the trust and this chapter do not provide a rule for allocating the receipt or disbursements to or between principal and income.

B. DUTY OF IMPARTIALITY (Texas Trust Code §116.004(b): The statute imposes a statutory fiduciary duty of impartiality with respect to the allocation of receipts and disbursements.

C. POWER OF ADJUSTMENT UNDER UNIFORM PRINCIPAL AND INCOME ACT (Texas Trust Code §116.005 and §116.006). The most controversial provision of the Principal and Income Act is the power of the trustee to adjust receipts between principal and income. Note that this ability runs both ways, from principal to income and *vice-versa*, although in this environment it is thought of as a way to increase the distribution for an income beneficiary. The power to adjust is given only to trustees – not to executors or administrators.

1. **Failure to Exercise.** Failure to exercise this power is not a breach of trust unless such failure is an abuse of discretion. [Tex. Trust Code §116.006 (a)]. However, the failure to even consider its exercise is a failure to exercise discretion.

¹⁰ Defined in Texas Trust Code §116.002 to mean “a personal representative or a trustee. The term includes an executor, administrator, personal representative, special administrator, and a person performing substantially the same function.”

2. **Exercise.** As with the failure to exercise, whether there is a breach of trust in the exercise of the power is measured by an abuse of discretion standard.
3. **Damages.** If the trustee is found to have breached its duty, then the beneficiaries are first made whole from the trust; *i.e.*, (i) if there is an over distribution of income, amounts are withheld from future distributions; (ii) if there is an under distribution the distributions are caught up; and (iii) if neither of those or possible, the trustee comes out of pocket to make it right. [Tex. Trust Code §116.006(c)]
4. **Request for Instructions.** Texas departs from the Uniform Act in §116.006(d), by allowing the trustee to seek court approval of the exercise of the power to adjust only “if the trustee believes that one or more beneficiaries of such trust will object to the manner in which the trustee intends to exercise or not exercise the power [to adjust].” The failure of a beneficiary to give the beneficiary’s consent, standing alone, is not a reasonable basis to believe that the beneficiary will object. The court is given jurisdiction to advance funds out of the trust to beneficiaries to prosecute or defend the action but ultimately awards attorney’s fees and costs pursuant to Texas Trust Code §114.064. This means that a party could be advanced funds from the trust to prosecute or defend the action but be required to repay the funds after the court makes its final award of fees and costs.

D. THE POWER TO ADJUST DOES NOT APPLY TO CHARITABLE REMAINDER UNITRUSTS (TEXAS TRUST CODE §116.007)

E. DETERMINATION AND DISTRIBUTION OF NET INCOME

1. **When The Right To Income Arises and Ends In The Administration Of Estates And Trusts:** The new act contains complex new rules dealing with these issues. These sections deal with the determination and distribution of net income from trusts and estates (Texas Trust Code §116.051 - 052) and apportionment at the beginning and end of income interests (Texas Trust Code §116.101 – 103).

The comments to this section provide that: “Section 201 (3) of the Uniform Principal and Income Act, as originally promulgated, provided that a beneficiary who receives a pecuniary amount outright shall also receive the interest or any other amount provided by the will, the terms

of the trust, or applicable law. This provision did not apply to a beneficiary who receives a pecuniary amount in trust. Prior Texas Law (Tex. Probate Code Ann. §378 (B) (f) did not differentiate between receipts of pecuniary amounts based on whether the amounts are to be received outright or in trust. Section 116.051(3) adopts the Texas Probate Code view regarding interest on pecuniary amounts by eliminating the differentiation between receipts of pecuniary amounts based on whether the amounts are to be received outright or in trust. Section 116.051(3) also provides that interest on pecuniary amounts begins one year after the death of the decedent for a pecuniary amount payable under a will and one year after an income interest ends for a pecuniary amount payable under a trust This is a departure from former Texas Probate Code Section 378(f), which provided that such interest begin one year after the court grants letters testamentary or letters of administration.”

Section 116.051(2)(B) authorizes the fiduciary to allocate interest on estate taxes to either principal or income. In contrast, former Section 378(B)(a) of the Texas Probate Code required that interest on estate taxes be charged against principal.

2. **Distribution to Residuary and Remainder Beneficiaries** (Texas Trust Code § 116.052): Section 116.052 provides that residuary legatees of estates are to receive net income earned during the period of administration on the basis of their proportionate interest in the undistributed assets when distributions are made. It changes (from prior state law) 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 administration.
3. **When Right To Income Begins and Ends** (Texas Trust Code §116.101): Section 116.101 provides that 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 a successive income interest. There are specific rules dealing with when an asset becomes subject to trust.

4. **Apportionment of Receipts and Disbursements when Decedent Dies or Income Interest Begins (Texas Trust Code § 116.102)** Texas Trust Code § 116.102(a) allocates income receipts or disbursements that become due prior to a decedent's death or prior to the inception of an income interest to principal. Texas Trust Code § 116.102(b) allocates income receipts from periodic payments that become due after the date of death or inception of an income interest to income. Income receipts or disbursements received after date of death or inception of an income interest which are not periodic or have no fixed due date accrue from day to day and are allocated to principal if accrued before date of death or inception of an income interest and to income if accrued thereafter. Texas Trust Code § 116.102(c) defines when an income or obligation is due.
5. **Apportionment of Receipts and Disbursements when Interest Ends (Texas Trust Code § 116.103)** This section deals with distribution of "undistributed income" in a trust which requires the distribution of income and which is defined as income actually received prior to the termination of an income interest. Undistributed income is required to be distributed to the income beneficiary, if living, or if deceased, to his or her estate. A fixed annuity or unitrust payment is prorated.
6. **What Constitutes Principal and Income:** These rules are dealt with in Texas Trust Code § 116.151 – § 116.206:
 - a. Texas Trust Code § 116.151 deals with the Character of Receipts. The general rule is that "money received from an entity (as defined in the act) is allocated to income. There are, however, exceptions to this general rule. Certain receipts from an "entity" are allocated to principal these are listed in Texas Trust Code § 116.151(b).
 - b. Texas Trust Code § 116.152 deals with Distributions from a Trust or Estate. This section provides that 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 purchase interest, and shall allocate to principal an amount received as a distribution of principal from such estate or trust.
 - c. Texas Trust Code § 116.153 contains special rules relating to business and other activities conducted by a trustee. The section provides that 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 trust's general accounting records, the trustee may maintain separate accounting records for its transactions, whether or not its assets are segregated from other trust assets. If a trustee elects to account separately then there are special rules relating to these accountings. Activities for which a trustee may maintain separate accounting records include:

- (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 involving certain derivatives and options.

- d. Texas Trust Code §116.161 deals with rules relating to the allocation of special (and not normally allocated) receipts to principal: This section allocates to principal: (1) certain assets received from a transferor during the transferor's 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 received from the sale, exchange, liquidation, or change in form of a principal asset; (3) amounts recovered by third parties to reimburse the trust for certain disbursements (4) proceeds taken by eminent domain; and (5) net income received in an accounting period during which there is no beneficiary to whom a trustee may or must distribute income;
- e. Texas Trust Code §116.162 deals with the allocation of receipts from rental property. Rent is allocated to income. Refundable deposits, security deposits are allocated to principal until earned.

- f. Texas Trust Code §116.163 deals with the allocation of obligations to pay money. This includes the allocation of principal and interest on notes receivable but also the allocation of receipts from the sale of obligations to pay money. Interest is allocated to income. Amounts received from the sale, redemption or other disposition of the obligation more than one year after it is purchased or acquired by the trustee are allocated to principal. If an obligation matures within one year after it is purchased or acquired, an amount received in excess of its purchase price or its value when acquired by the trust must be allocated to income.
- g. Texas Trust Code §116.164 deals with the allocation of the proceeds from insurance policies. The proceeds from life insurance and other policies where the trustee is named beneficiary are allocated to principal. Dividends on insurance are allocated to income if the premiums are paid from income and to principal if the premiums are paid from principal. Proceeds from a contract that insures the trustee against loss of occupancy or other use by an income beneficiary, loss of income, or, certain loss of profits from a business are allocated to income.
- h. Texas Trust Code §116.171 provides that, subject to certain restrictions, if a trustee determines that an allocation is “insubstantial”, the trustee may allocate the entire amount to principal.
- i. Texas Trust Code §116.172 deals with the allocation of Deferred Compensation Annuities and Similar Payments. To the extent that the payer characterizes a payment as interest or a dividend or payment made in lieu of interest or a dividend, the payment shall be allocated to income. The balance of the payment and any other payment received in the same accounting period that is not characterized as interest, a dividend, or stock ownership plans are allocated to principal. There are special rules relating to allocations in situations where no part of the payment is characterized as interest, a dividend or an equivalent payment.
- j. Texas Trust Code §116.173 deals with the allocation of certain liquidating assets. This replaces prior Texas Trust Code §113.109 which dealt with depletion with respect to property, other than natural resources, subject to depletion.

- k. Texas Trust Code §116.174 deals with the allocation of receipts from Minerals, Water and other natural resources. These are new rules.
- (1) Nominal delay rental or nominal annual rent on a lease is allocated to income.
 - (2) Production payments are allocated to income if the agreement creating the production payment provides a factor for interest or its equivalent. The balance is allocated to principal.
 - (3) If an amount received as a royalty, shut-in-well payment, take-or-pay payment, bonus, delay rental is more than nominal, the trustee shall allocate the receipt equitably.
 - (4) If an amount is received from a working interest or any other interest not described above, the trustee must allocate the receipt equitably.
 - (5) An amount received on an account of an interest in water that is renewable must be allocated to income. If the water is not renewable, the receipt must be allocated equitably.
 - (6) UPIA applies whether or not a decedent or donor was extracting minerals, water, or other natural resources before the interest became subject to the trust. The purpose of this section 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.
 - (7) A trustee may allocate a receipt from any interest in minerals, water, or other natural resources the trust owns on January 1, 2004, in the manner provided by UPIA or in any lawful manner used by the trustee prior to January 1 2004, to make the same allocation. The trustee shall allocate a receipt from any interest in minerals, water, or other natural resources acquired by the trust after January 1, 2004 as provided by UPIA.

- (8) An allocation of a receipt under this section is presumed to be equitable if the amount allocated to principal is equal to the amount allocated by the Internal Revenue Code of 1986 as a deduction for depletion of the interest.
- I. Texas Trust Code §116.175 deals with the allocation of receipts from timber. This section requires a trustee to allocate the net receipts from the sale of timber and related products as follows:
 - (1) to income to the extent that the amount of timber removed does not exceed the rate of growth of the timber during the accounting periods in which a beneficiary has a mandatory income interest;
 - (2) to principal to the extent that the amount of timber removed exceeds the rate of growth of the timber or the net receipts are from the sale of standing timber;
 - (3) to 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 the rules set forth in the two preceding paragraphs

This section also provides that in determining net receipts to be allocated a trustee shall deduct and transfer to principal a reasonable amount of depletion.

This section applies whether or not a decedent or transferor was harvesting timber from property before it became subject to the trust.

Finally, this section provides that if a trust owns an interest in timberland on January 1, 2004, the trustee may allocate a net receipt from the sale of timber and related products in the manner provided by UPIA or any lawful manner used by the trustee before January 1, 2004 to make the allocation. If the trust acquires an interest in timberland after January 1, 2004, the trustee must allocate receipts from the sale of timber and related products in the manner provided by this

section of UPIA.

- m. Texas Trust Code §116.176 allows a trustee to allocate receipts in order to comply with certain requirements relating to a federal estate tax marital deduction. More particularly this section relates to the requirement that marital deduction trust property be productive.
- n. Texas Trust Code §116.177 deals with the allocation of receipts from derivatives and options. To the extent that a trustee does not account under Texas Trust Code §116.153 for transactions in derivatives, the trustee shall allocate to principal receipts from and disbursements made in connection with these transactions. If a trustee grants an option to buy property from a trust the amount realized from the option must be allocated to principal. A gain or loss realized on the exercise of an option, including an option granted to a settlor of the trust for services rendered must be allocated to principal.
- o. Texas Trust Code §116.178 deals with the allocation of receipts from certain asset-backed securities. "Asset backed securities" means an asset whose value is based upon the right it gives the owner to receive distributions from proceeds of financial assets that provide collateral for the security. 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. If a trust receives one or more payments in exchange for the trust's 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 will result in the liquidation of the trust's interest in the security over more than one accounting period, the trustee shall allocate 10 percent of the payment to income and the balance to principal.
- p. Texas Trust Code §116.201 deals with disbursements of income. This section provides that:

- (1) To the extent that 116.051(2)(b) or (c) does not apply¹¹, the following disbursements should be made from income:
 - (2) one half of the regular compensation of the trustee and of any person providing investment advisory or custodial services to the trustee;
 - (3) one half of all expenses for accountings, judicial proceedings, or other matters that involve both the income and remainder interests;
 - (4) all of the other ordinary expenses incurred in connection with the administration, management, or preservation or 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
 - (5) recurring premiums on insurance covering the loss of a principal on insurance covering the loss or a principal asset or the loss of income from or use of the asset.
- q. Texas Trust Code §116.202 deals with disbursements of principal and provides that a trustee shall make the following disbursements from principal:
- (1) The remaining one half of: (1) the regular compensation of the trustee and of any person providing investment advisory or custodial services to the trustee and (2) all expenses for accountings, judicial proceedings, or other matters that involve both the income and remainder interests;

¹¹ Texas Trust Code §116.051 (2) B & C provide that: A fiduciary shall determine the remaining net income in a decedent's estate or a terminating income interest under the rules in Subchapters C, D, and E which apply to trustees and by: (B) paying from income or principal, in the fiduciary's discretion, fees of attorneys, accountants, and fiduciaries; court costs and other expenses of administration; interest on death taxes, but 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 will not cause the reduction or loss of the deduction; and (C) paying from principal all other 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.

- (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 construe the trust or to protect the trust or its property;
- (5) premiums paid on a policy of insurance (other than policies covering the loss of a principal asset or the loss of income from or use of the asset) which the trustee is the owner and beneficiary;
- (6) estate, inheritance, and other transfer taxes, including penalties, apportioned to the trust; and
- (7) disbursements related to environmental matters.
- (8) This section also provides that 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.

r. Texas Trust Code § 116.203 contains provisions allowing a trustee to transfer to principal "a reasonable amount of the net cash receipts from a principal asset that is subject to depreciation. This section further provides that a trustee may not make any such allocation:

- (1) for real property used by a beneficiary as a residence;
- (2) for tangible personal property held or made available for use by a beneficiary for his or her personal use or enjoyment;
- (3) during the administration of a decedent's estate;
- (4) if the trustee is accounting for a business activity under the

special rules of Texas Trust Code §116.153.

- (5) This section also provides that depreciation allocations to principal need not be held as a separate fund.
- s. Texas Trust Code §116.204 provides for transfers from income to reimburse principal. This section provides that if a trustee makes or expects to make a principal disbursement, 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 disbursements.
- t. Texas Trust Code §116.205 relates to the payment of income taxes. This section provides that:
 - (1) A tax required to be paid by the trustee based on receipts allocated to income must be paid from income.
 - (2) A tax required to be paid by the 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.
 - (3) A tax required to be paid by the trustee on the trust's share of an entity's taxable income must be paid proportionately: (1) from income to the extent that receipts from the entity are allocated to income; and (2) from principal to the extent that the receipts from the entity are allocated to principal; and the trust's share of the entity's taxable income exceeds the total receipts described above.
 - (4) This section also provides that, for the purposes of this section, receipts allocated to principal or income must be reduced by the amount distributed to a beneficiary from principal or income for which the trust receives a deduction in calculating the tax.
- u. Texas Trust Code §116.206 relates to adjustments between principal and income because of taxes. This section provides that a fiduciary may make adjustments between principal and income to offset the shifting economic interests or tax benefits between income beneficiaries and remainder beneficiaries which arise from:

(1) elections and decisions, other than those specifically provided for below; (2) an income tax or 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.

(1) This section also provides that if an estate tax marital deduction or charitable contribution deduction is reduced because a fiduciary deducts and amount paid from principal for income tax purposes instead of deducting it or 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.