Introduction to Colorado's New Principal and Income Act

by James R. Wade

In 2000, the Colorado legislature adopted the recently revised Uniform Principal and Income Act ("Act"). Nationally, the Act is intended to supercede both the original 1931 Act and the 1962 Revised Act. The Act becomes effective in Colorado on July 1, 2001,[1] and is applicable to post-July 1, 2001, estates and trusts that are then irrevocable. It also applies to pre-July 1, 2001, estates and trusts unless the fiduciary elects to opt out of the Act by July 1, 2002. As discussed below, the trustee's election to make an adjustment in favor of the income account is an important new concept. Once made, elections are irrevocable and notice of the election should be given to the beneficiary. This article discusses the purposes and provisions of the Act, and businesses operated by the trust.

Purposes of the Act

The main purpose of the Act is to provide rules for the allocation of receipts and disbursements in the case of split interest trusts. In a split interest trust, the current income interest is in one beneficiary or beneficiaries and the ultimate remainder interest is in another beneficiary. For example, suppose a trust receives a royalty payment, an annuity payment, or a payment for the harvest of timber. In a split interest trust, the question is whether the receipt is payable to the current income beneficiary or whether it is added to the corpus for the benefit of the ultimate remainder beneficiary.

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In addition to addressing questions regarding split interest trusts, these rules govern the allocation of receipts during the period of probate administration where the residuary beneficiary is itself a trust. Separately, the Act provides probate administration rules for dealing with the allocation of receipts and disbursements between pre-residuary pecuniary and specific bequests, on the one hand, and the residue, on the other hand. The Act also focuses on non-probate transfers, including using revocable trusts as will substitutes and establishing a set of rules to cover both testamentary and non-probate documents.

Provisions of the Act

The Act has two core concepts. Initially, the Act provides default rules for gaps in a trust not covered by the governing instrument. Where the Act and a trust instrument are inconsistent, the terms of the trust apply.[2] Therefore, it is possible to draft around or opt out of the provisions of the Act. The "terms of the trust" that are at issue with the Act may be established by spoken words and conduct as well as by the writing itself.[3] Second, consistent with the rules of prudence and impartiality, the adjustment and allocation provisions of the Act are to be applied "based on what is fair and reasonable to all of the beneficiaries."[4]

Adjustment Power

The radical innovation under the Act is a grant of discretionary authority to a trustee to allocate some portion of the corpus (presumably realized capital gains, and then unrealized gains) to the income account in cases where the governing instrument limits the life beneficiary's interest to income and does not provide for the invasion of the corpus. The Act also authorizes reallocations of income to the corpus.[5] Under the provisions of the Uniform Prudent Investor Act[6] a trustee may invest for a total return (that is, current ordinary dividend and interest income together with appreciation in the value of the underlying assets), including investing in assets expected to appreciate in value. A trustee may choose to do so in an attempt to maintain or exceed the expected rate of inflation in the economy.

Without an adjustment power, there is a risk that investment in a growth-oriented portfolio will result in lower current dividends for the income beneficiaries and a disproportionate benefit for the remainder beneficiary. The list of factors relevant to the exercise of discretion under the Act[7] is similar to those relevant to investment decision-making under the Prudent Investor Rule.[8] Similarly, an adjustment may be appropriate on the sale of an unproductive or under-productive asset to compensate the income account out of the sale proceeds (corpus) for past deprivation of income.

The notice provision in the Act[9] provides that before making an equitable adjustment, or deciding not to do so, a trustee may give notice to the current income beneficiaries and those who would be remainder beneficiaries if the trust terminated. The notice must allow at least thirty days to provide the trustee with writ-

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ten objections. If no objection is received, the trustee may proceed without liability risk. However, if an objection is received, the trustee may notify the beneficiaries of the decision not to proceed with the adjustment. Either the trustee or beneficiary may petition the court to order that an adjustment be made. The Act protects the trustee from claims by a beneficiary for proposing an adjustment and failure to propose an adjustment.[10]

Generally, the adjustment power will not be applied in the majority of modern family trust instruments. This is because modern drafting often provides flexibility for the protection of beneficiaries through the grant of trustee discretion to invade the corpus for the benefit of a beneficiary or class of beneficiaries. The trustee's discretion usually is limited by the estate tax protective ascertainable standard of health, education, support, and maintenance.[11] It is only when there is no provision for corpus invasion that the allocation power becomes important.

However, to protect the integrity of tax motivated transfers, there are certain adjustments that cannot be made. These include, but are not limited to, the following:

1) diminishing the income or the value of the income interest in a marital deduction asset;
2) reducing the actuarial value of the income interest contrary to the intent to qualify for a gift tax exclusion;
3) affecting assets set aside for charitable purposes;
4) where the possession or exercise of a power would cause income to be taxed to the trustee or cause trust assets to be included in an estate for federal estate tax purposes;
5) where the trustee is a beneficiary; and
6) where the trustee is not a beneficiary, but would benefit directly or indirectly from the exercise of a power.[12]

In the area of adjustments, the new Act covers the general power to adjust between the income and the corpus;[13] other adjustments are authorized regarding depreciation, under-productive, and unproductive assets;[14] and adjustments between principal and interest accounts because of tax burdens.[15]

For example, assume the following facts: a probate residue, worth $2 million, is divided equally between a charity and family members. Under the Act,[16] the estate's net income is paid to the residuary beneficiaries. During the period of administration, $500,000 in estate taxes are paid out of the general residue, reducing the residue to $1,500,000. The taxes are attributable to the family share of the residue because the one-half to charity is protected by the charitable deduction. Is the income on $2 million, prior to the tax payment, paid equally to the two sides of the residue? After the tax payment, is the income on the remaining $1,500,000 split or is two-thirds paid to the charitable share?

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The former Act did not give clear guidance on this issue. There were no Colorado cases, and the cases in other jurisdictions were divided. Some states applied a rule of convenience, splitting the allocation equally, noting that it would be too burdensome to recalculate the respective shares of the residue every time a distribution was made with respect to one share but not the other. Other states opted for calculating income based on the respective values of the shares immediately prior to each distribution. This is the approach that the Act adopts.[17]

Based on separate facts, suppose that a will created a marital deduction trust devised out of the residue of the estate using a formula that fixes the amount by reference to the adjusted gross estate for federal estate tax purposes. Administration expenses can be deducted by the personal representative either on the fiduciary income tax or on the federal estate tax return.

If the expenses are taken as income tax deductions, the amount of the marital deduction trust and the income distribution is not diminished. If the expenses are taken as a federal estate tax deduction, the value of the estate and the amount of the marital deduction is diminished. However, the income distributable to the beneficiaries is undiminished by the additional amount of tax due that would have been on account of the deductions. In some cases, this dilemma had led to the requirement of an equitable adjustment described as the Bixby-Warms Adjustment,[18] which is provided for in the Act as a mandatory adjustment.[19] However, commonly used language in will drafting may absolve the personal representative from making any equitable adjustments and, in this case, often will obviate the problem.[20]

Aside from the authorization to make equitable adjustments, the Act is not substantially different from the former Act. The Act continues the basic rules regarding the allocation of income and expenses in periods of transition. Moreover, it addresses periods of transition such as death, commencement of an estate or trust, and termination of a trust.[21]

Allocation of Income And Expenses

The provisions of the Act are, with one important exception, similar to the former rules regarding the allocation of net probate income earned during the period of estate administration. Under the Act,[22] a specific devisee is entitled to the net income earned on the assets. A pecuniary devisee is entitled to the amount of interest provided by the governing documents or by statute in Colorado.[23] The balance of the income is allocated to the residuary beneficiary.

Under the former Act, virtually all expenses paid during the period of administration were charged against the corpus. Therefore, the income of the estate was distributable almost entirely to the income beneficiary in cases where the residuary beneficiary was a trust. However, under the Act,[24] the fiduciary has discretion to pay fees, costs, expenses of administration, and death taxes from trust income or the corpus. Similar to the former rule, all other expenses, such as debts, funeral expenses, and taxes are payable out of the corpus.

The new rule makes the treatment of charging of fees under split interest arrangements consistent. Under the former rule, all fees during the period of probate administration were paid out of the corpus, but when the fiduciary changed hats from personal representative to testamentary trustee, an allocation of fees applied. Similarly, the former Act created a distinction between an "estate" administered with a revocable trust and administration with a will. The revocable trust format provided for an allocation of fees between the corpus and income, but the will format did not allocate fees.

In the area of trust accounting, there is one change that is especially important. Under the Act,[25] trustee fees, investment and custodial fees, and accounting expenses are to be paid one-half from income and one-half from the corpus. Under the former Act, these expenses were paid from income, subject to trustee discretion to charge fees up to one-half against the corpus. As a matter of practice, under the former Act, most other expenses were charged solely against income.[26]

The Act also is more elaborate than the former Act in providing accounting and characterization rules affecting income or the corpus and is applicable to a wider range of assets. These include:

1) discretion to prepare separate accountings for businesses conducted by the trustee within the trust estate;[27]
2) rental property;[28]
3) insurance policies;[29]
4) deferred compensation and annuities;[30]
5) liquidating assets (such as leasehold patents, copyrights, and royalties);[31]
6) mineral, water, and other natural resources;[32]
7) timber;[33]
8) derivatives and options;[34] and
9) asset backed securities.[35]

Some of the more common issues encountered with these kinds of assets are discussed below.

Businesses Operated By the Trust

In practice, questions occasionally arise regarding the handling of receipts and disbursements made by a trustee in connection with the conduct of a business operated by the trust (usually not in separate entity format).[36] For example, if a business produces $100,000 in net income, under good business principles, $75,000 should be kept in the business to modernize equipment or to promote generally the growth of the business. The trust life income beneficiary is A and the remainder beneficiaries are B and C. A claims entitlement to the entire net income, and B and C claim that the income should be limited to $25,000. The Act resolves this issue by allowing the trustee to diminish the income by the amount of reasonable business expenses.

Handling depreciation in connection with the management of real estate in a trust has traditionally been a source of contention. Under the former Act as adopted in some states, creating an actual cash reserve out of income to compensate the corpus account for depreciation in value of the corpus assets was mandatory. This was criticized by income beneficiaries who noted that the value of real estate was actually increasing in value over time and not depreciating.

When the former Act was revised, the taking of depreciation was discretionary for the trustee, and it did not provide guidance to the trustee. The Act continues the pattern of discretion in the trustee. However, the Act does define depreciation as "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."[37] This new definition is helpful in including economic obsolescence in the concept of depreciation. The Act provides that depreciation may not be taken on personal use assets, such as a beneficiary-owned residence, and that a separate fund need not be created.

Depreciation also may be taken for income tax purposes in a way that is not consistent with actual trust administration or accounting. For example, assume that a building (exclusive of the non-depreciable land on which it sits) is worth $100,000 and has a useful life of ten years. Further, assume that the building actually is maintaining its value. The building produces $10,000 per year in income that is passed to the income beneficiary. For income tax purposes, during a ten-year period the depreciation is offset against the trust income, with the result that there is zero distributable net income for income tax purposes. If the building is sold for $100,000 after ten years, there is no economic gain or loss but, for income tax purposes, the trust has a gain of $100,000. That gain is subject to a 20 percent capital gains tax of $20,000, which is normally payable out of the corpus.

In the case of *Will of Pross*,[38] a case with similar but not identical facts, the probate judge found that, without an adjustment, the income account would be unjustly enriched and ordered that the income account, which had benefitted from the income tax depreciation deduction, reimburse the corpus account in the amount of the capital gains tax. The Act provides for the same adjustment.

Business Entity Ownership

In the area of business entity interest ownership, the former Act primarily deals with the characterization of receipts from corporations.[39] There was an issue, under the former Act, whether the recipient trustee had to examine the accounting records of the payor-corporation to determine the extent to which the receipt would be considered a distribution of current corporate income (a dividend) or a capital transaction. A capital transaction concerns the distribution of some portion of the corporation's underlying assets, thus involving, *inter alia*, the treatment of stock dividends. The former Act generally adopted a bright line rule that allocated such distributions to be treated as income, absent special circumstances.[40]

The Act broadens the definition of an "entity" to include partnerships, limited liability corporations, mutual funds, real estate investment trusts, and trust funds. In general, distributions of money from entities are characterized as income with specific rules for corpus allocations. For example, rules regarding redemptions, partial liquidations, capital gain distributions, and mutual funds as corpus allocations are set forth in the Act. The characterization of mutual fund distributions for principal and income purposes now follows the income tax characterization, which allows some short-term capital gains to be characterized as income for income tax reporting purposes.[41]

A trustee may receive payments on account of wasting assets, which are assets that may become totally exhausted. Examples include: (1) oil and gas production;[42] (2) mineral extraction;[43] (3) receipt of a fixed term annuity;[44] (4) other royalty receipts;[45] and (5) leaseholds, patents, and copyrights.[46] The Act adopts a bright line rule for most payments, allocating 10 percent to current income and 90 percent to replacement of the corpus. On the other hand, if the underlying asset is renewable in nature, the receipt is allocated entirely to income.

Agricultural Products

In agricultural areas such as Colorado, the treatment of receipts from the sale of agricultural products is of special interest. The former Act contained a special provision regarding livestock.[47] For example, a trustee could receive receipts from the sale of (1) timber (income to the extent that the rate of growth is not exceeded); (2) livestock; (3) grain; (4) fruit from orchards; and (5) water. The Act covers timber and water specifically, but it does not include allocation of receipts from sale of livestock, grain, or fruit. Timber receipts are income to the extent that the growth rate is not exceeded.[48] The allocation of receipts from the sale of water depends on whether the water resource is renewable (rights from a renewable stream) or non-renewable (from a closed basin well).

The provision of the prior Act regarding livestock was that all offspring or increase are deemed principal to the extent necessary to maintain the original number of animals, with the remainder deemed income.[49] The rule seems to continue to be workable even though not specifically covered under the Act. If an asset is renewable, the receipt is allocated to income. However, if an asset is not renewable, 90 percent is allocated to the corpus and 10 percent is allocated to income.

According to the Act, when a trustee is dealing with deferred compensation, annuities, liquidating assets, natural resources, and timber or asset-backed securities (subject to the general fiduciary principles[50] and the adjustment power[51]), a trustee may disregard an "insubstantial" allocation and allocate the receipt entirely to the corpus. An allocation generally is presumed insubstantial if the allocation would increase or decrease current trust net income by less then 10 percent or if the value of the assets producing the receipt is less than 10 percent of the total value of the trust assets.

Finally, the Act deals with environmental problems that may be faced by property held in trust. Disbursements for reclamation, environmental assessments, removal of contamination, remedial actions, and monitoring are allocable to the corpus and not payable out of current income.

Conclusion

The provisions of the Act read, in some places, similarly to a tax code. The drafting is detailed and complex, with numerous cross references. Practitioners should study the provisions carefully in cases where accounting issues arise in connection with either estate or trust administration.

NOTES

1. CRS § 15-1-434.
2. CRS § 15-1-403(1)(a), (3), and (4).
3. CRS § 15-1-402(12).
4. CRS § 15-1-403(2).
5. CRS § 15-1-404.
6. CRS §§ 15-1.1-101 *et seq.*
7. CRS § 15-1-404(2).
8. CRS §§ 15-1.1-101 *et seq.*
9. CRS § 15-1-405.
10. CRS § 15-1-404(7).
11. IRC § 2041(b)(1)1.
12. CRS § 15-1-404(3).
13. CRS § 15-1-404.
14. CRS § 15-1-428.
15. CRS § 15-1-431.
16. CRS § 15-1-406.
17. CRS § 15-1-407.
18. Wade and Parks, *Colorado Law of Wills, Trusts and Fiduciary Administration* § 34.15 (Denver, CO: CLE in Colorado, Inc., 1999).
19. CRS § 15-1-431(2).
20. *See also* Wade and Parks, *supra,* note 18 at §§ 21.31-36, 21.53, and 21.63 (regarding selection and valuation of assets to satisfy marital deduction gifts and handling deductions).
21. CRS §§ 15-1-406 and -408.
22. CRS § 15-1-406.
23. CRS § 15-12-904.
24. CRS § 15-1-406(1)(b).
25. CRS § 15-1-426.
26. CRS § 15-1-427(1)(g).
27. CRS § 15-1-413.
28. CRS § 15-1-415.
29. CRS § 15-1-417.
30. CRS § 15-1-419.
31. CRS § 15-1-420.
32. CRS § 15-1-421.
33. CRS § 15-1-422.
34. CRS § 15-1-424.
35. CRS § 15-1-425.
36. CRS § 15-1-413.
37. CRS § 15-1-428.
38. 90 Misc.2d 895, 396 N.Y.S.2d 309 (Surr. 1977).
39. CRS § 15-1-408.
40. CRS § 15-1-408.
41. CRS § 15-1-411(3)(d).
42. CRS § 15-1-421.
43. CRS § 15-1-421.
44. CRS § 15-1-420.
45. CRS § 15-1-421.
46. CRS § 15-1-420.
47. CRS § 15-1-411.
48. CRS § 15-1-422.
49. Wade and Parks, *supra*, note 18 at § 34.24 (regarding sale of grain and fruit).
50. CRS § 15-1-403.
51. CRS § 15-1-404. ■