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ADMINISTRATION OF PRINCIPAL AND INCOME FOR THE COMMONWEALTH: A SURVEY OF THE KENTUCKY PRINCIPAL AND INCOME ACT

by Kevin R. Ghassomian, Esq.[+] *and Jennifer T. Leonard*[*]

I. INTRODUCTION

Most fiduciaries have encountered estates and trusts with current and future beneficiaries whose interests are at odds with each other. Generally, the current beneficiary receives distributions of income and the future beneficiary is the ultimate recipient of principal.[1] Thus, it is up to the fiduciary to determine whether a receipt of property is to be treated as "income," and thereby currently distributable, or "principal," to be held for the residuary or remainder beneficiary.[2] Likewise, the fiduciary must decide whether to charge expenses of the estate or trust against income or principal. As one can surmise, these determinations are fraught with tension, as each beneficiary lobbies to maximize its share of the estate or trust property.[3] The fiduciary, alone in the midst of these competing interests, must remain impartial, balancing receipts and disbursements between income beneficiaries and remaindermen without favor.[4]

As most fiduciaries can attest, maintaining impartiality is difficult; but it has become more practicable due in large part to the ascendance of "total return" investing, an approach to fiduciary asset management that seeks to maximize gains of the estate or trust *as a whole* regardless of whether returns fall on the

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1. The terms "principal" and "corpus" are used interchangeably in the authority cited for this article. Generally, "principal" is used in state statutes and "corpus" is used in the Internal Revenue Code. *Fiduciary Accounting Income Under State Law*, Tax Management: Estates, Gifts, and Trusts Portfolios: Trustee Investments (BNA) No. 852-2nd, at A-55 (Jan. 10, 2005). However, their definitions are the same. *Id.*

2. Mark R. Gillett & Katheleen R. Guzman, *Managing Assets: The Oklahoma Uniform Principal and Income Act*, 56 OKLA. L. REV. 1, 1 (2003).

3. *Id.*

4. RESTATEMENT (SECOND) OF TRUSTS § 183 (1959) (stating, "[w]hen there are two or more beneficiaries of a trust, the trustee is under a duty to deal impartially with them"). *See also* Alyssa A. DiRusso & Kathleen M. Sablone, *Statutory Techniques for Balancing the Financial Interests of Trust Beneficiaries*, 39 U.S.F. L. REV. 261, 262 (2005).

income or principal side of the ledger.[5] Although "total return" investing tends to improve overall financial yields, the fiduciary's investment decisions will either have an income bent, favoring current beneficiaries, or a growth orientation that decidedly favor the remaindermen.[6] Inevitably, such investment tilts exacerbate conflicts between current and future beneficiaries, making it all but impossible for a fiduciary to remain even-handed in administering income and principal interests.[7]

Fortunately, the fiduciary's balancing act has been steadied by various legislative initiatives including, most notably, the 1997 Uniform Principal and Income Act ("Uniform Act").[8] The Uniform Act effectively addresses tensions between current and future beneficiaries by establishing a protocol for fiduciary administration in accordance with the dual goals of impartiality and optimum investment returns.[9] Kentucky's version of the Uniform Act, known as the Kentucky Principal and Income Act ("Kentucky Act"),[10] went into effect on January 1, 2005.[11]

For the most part, the provisions of the Kentucky Act mirror those of the Uniform Act; however, there are several notable differences. This article examines variations between the Uniform Act and the Kentucky Act and also details many of their common provisions. Section II opens with a discourse on the historical predecessors and influences that led to the adoption of the Kentucky Act, including a brief foray into the evolution of the "total return" investing. Section III picks up with a general overview of the Kentucky Act, its noteworthy provisions and departures from the terms of the Uniform Act. Section IV closes with a cursory review of the Internal Revenue Service ("IRS") response to the Uniform Act and its state law counterparts.

II. LEGISLATIVE BACKGROUND

Through the years, market trends and corresponding changes in investment theory have led to a gradual modification of the rules governing income and principal administration.[12] Specifically, a rigid fiduciary accounting regime that sometimes arbitrarily distinguished between income and principal interests slowly gave way to a new flexible approach, integrating a fiduciary's management and investment of these interests into a unified portfolio of assets.[13]

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5. *See* DiRusso & Sablone, *supra* note 4, at 262.
6. *Id.*
7. *Id*.
8. UNIF. PRINCIPAL & INCOME ACT (amended 1997), 7B U.L.A. 131-92 (2000).
9. *See generally id.*
10. The Kentucky Act repealed the Kentucky Revised Uniform Principal and Income Act. KY. REV. STAT. ANN. §§ 386.191-386.349 (LexisNexis 1999 & Supp. 2005) (repealed January 1, 2005).
11. KY. REV. STAT. ANN. §§ 386.450-§386.504 (LexisNexis 1999 & Supp. 2005).
12. *See generally* DiRusso & Sablone, *supra* note 4, at 262.
13. *Id*.

This section provides background on the development of this approach, beginning with its roots in the "prudent man rule" and leading ultimately to the near nationwide adoption of the Uniform Act and its passage in Kentucky.

A. *The Prudent Man Rule.*

The first widely accepted standard governing fiduciary investment discretion was the "prudent man rule."[14] Initially articulated by the Massachusetts Supreme Judicial Court in *Harvard College v. Amory*,[15] it required fiduciaries, in this case a trustee, "to observe how men of prudence, discretion and intelligence manage 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 the capital to be invested."[16] As it was applied by subsequent courts, the "prudent man rule" evolved to require the exercise of "prudence" in making or retaining *each individual investment*, failing to take into account the role of a particular asset in the fiduciary's overall mix of investments.[17]

This myopic interpretation of investment "prudence" was picked up and effectively endorsed by the *Restatement (Second) of Trusts* in 1959.[18] Thereafter, many states codified it into law, some going so far as to restrict fiduciaries to investing in an approved list of assets.[19] As investment options increased, however, the rigidity of the "prudent man rule," as it had been applied, became evident, exposing the failure of the courts to keep pace with contemporary investment theory.[20] The law had to change if fiduciaries were to maintain respectable rates of return on their investments.[21] Mercifully, it did change thanks mainly to the advent of "modern portfolio theory" and the "total return" approach to investing, the philosophical precipitators of current fiduciary investment practices.[22]

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14. *Id.* at 264. *See also* Mayo Adams Shattuck, *The Development of the Prudent Man Rule for Fiduciary Investment in the United States in the Twentieth Century*, 12 OHIO ST. L.J. 491 (1951) (discussing in detail the prudent man rule and its integration into trusts).

15. 26 Mass. 446 (1830).

16. *Id*. at 461.

17. *See* DiRusso & Sablone, *supra* note 4, at 266. *See also*, RESTATEMENT (THIRD) OF TRUSTS § 227 (1992) (noting that the courts failed to apply the generality and flexibility of the rule as initially intended).

18. RESTATEMENT (SECOND) OF TRUSTS § 227 (1959).

19. *Id.* at § 227 cmt. p (noting "[i]n some States the statutes are more restricted, allowing only such investments as government securities, first mortgages on land, and certain types of bonds"). Later, states adopted the more flexible prudent man rule. RESTATEMENT (THIRD) OF TRUSTS § 227 (Introduction, pp.3-7) (1992).

20. *See generally*, DiRusso & Sablone, *supra* note 4, at 266-67.

21. *Id*.

22. *Id*.

B. *Modern Portfolio Theory and Total Return Investing*

1. Modern Portfolio Theory

Modern portfolio theory is premised on two fundamental tenets.[23] The first is that investment returns are correlated to the degree of risk assumed by the investor in making its investment selections.[24] Such risk includes both "market risk," which applies systemically to all investments as determined by external factors, and "non-market risk," which applies to individual investments as dictated by events and occurrences peculiar to the investment itself.[25]

To illustrate, "market risk" derives from events like elections, natural disasters and other macroeconomic forces, whereas "non-market risk" emanates from the investment itself such as the death of a company's chief executive officer, a strike by its employees or the development of an innovative new product.[26] Investors generally cannot protect against market risk, as it applies to everyone engaged in the marketplace; thus, differentiation of investment returns depends on one's ability to contain "non-market risk."[27] Modern portfolio theory presumes that the "prudent" investor will act to reduce non-market risks through diversification of asset holdings.[28] Diversification as a risk reduction technique is based on the simple notion that different assets react differently to the same systemic influences; thus, higher yields by one company will offset, to some degree, the lower yields of another.[29]

The second tenet of modern portfolio theory is market efficiency.[30] Generally, modern portfolio theory presumes that the price of an investment is based upon the sum total of all the information currently known by the public about that investment.[31] Thus, no matter how diligent an investor is in gathering information about a company, its price will have already adjusted to incorporate that information before the investor can act upon it.[32] As such, proponents of modern portfolio theory assert that it is futile to try to "beat" the market and

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23. *Id*. *See also* Jerold I. Horn, *Prudent Investor Rule, Modern Portfolio Theory, and Private Trusts: Drafting and Administration Including the "Give Me Five" Unitrust*, 33 REAL PROP. PROB. & TR. J. 1, 7 (1998).

24. *See* Horn, *supra* note 23, at 12-17.

25. *Id.* at 13.

26. *Id.*

27. *See generally id*. at 13, 15-16. *See also*, RESTATEMENT (THIRD) OF TRUSTS § 227 (Introduction p. 6) (1992).

28. Horn, *supra* note 23, at 15-16.

29. *Id.* at 15-16. *See also*, RESTATEMENT (THIRD) OF TRUSTS § 227 (Reporter's notes, pp. 74-76) (1992).

30. Horn, *supra* note 23, at 16.

31. *Id. See also* RESTATEMENT (THIRD) OF TRUSTS § 227 (Reporter's Notes, pp. 74-75) (1992).

32. Horn, *supra* note 23, at 16. *See also* RESTATEMENT (THIRD) OF TRUSTS § 227 (Reporter's Notes, pp. 74-75) (1992).

conscientious or "prudent" investors should merely attempt to mirror its performance.[33]

2. Total Return Investing.

Traditionally, fiduciaries concerned themselves with the preservation of principal; thus, they were long-inclined to favor bonds when investing estate and trust assets.[34] After World War II, however, bond yields began to drop so fiduciaries responded by increasing their equity holdings.[35] This trend continued after the late 1960s, throughout the 1970s and into the early 1980s, as fiduciaries sought to outpace rising rates of inflation by enhancing their equity positions.[36]

"In the 1990s, falling dividend yields and interest rates" along with a "raging bull market" resulted in a heightened "tension between income and remainder beneficiaries."[37] Whether assets were invested in equities or bonds, during this period, neither could produce enough income, as traditionally defined, to provide income beneficiaries with a satisfactory return, thereby, compromising the fiduciary's ability to satisfy its duty of impartiality.[38] States responded by enacting remedial legislation that allowed for "total return" investment which permitted fiduciaries to manage estate and trust portfolios for maximum overall gains, without regard to traditional notions of income and principal oriented investments.[39]

This focus on "total return" fit well with the modern portfolio theory's emphasis on diversification, enabling fiduciaries to run the gamut of investment options based upon the risk tolerance of the beneficiaries.[40] Thus, total return investing considers the aggregate return of interest, dividend, rent income, and capital appreciation without regard to rigid fiduciary accounting rules, simultaneously satisfying the needs of income beneficiary with that of remainderman.[41]

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33. Horn, *supra* note 23, at 16. (stating that "investors are not able to outperform the market at whatever mix of risk and reward they seek, and therefore, any attempt to do so is futile, counterproductive, and wasteful"). *See also* RESTATEMENT (THIRD) OF TRUSTS § 227 (Reporter's Notes, pp. 75) (1992).

34. DiRusso & Sablone, *supra* note 4, at 268.

35. *Id.*

36. *Id.*

37. *See* Adam J. Wiensch & L. Elizabeth Beetz, *The Liberation of Total Return*, TRUSTS AND ESTATES, Apr. 2004, at 44.

38. *See generally id.*

39. *Id.* This theory rejects the idea that investors should assess risk and return of each investment before adding it to their portfolio. *See also*, DiRusso & Sablone, *supra* note 4, at 268.

40. *See generally*, Wiensch & Beetz, *supra* note 37, at 44.

41. *See generally*, DiRusso & Sablone, *supra* note 4, at 268.

C. *The Prudent Investor Rule and the Uniform Prudent Investor Act*

The coincidence of modern portfolio theory and total return investing had a significant impact on fiduciary investment practices, as there was now a broadly accepted body of empirical and theoretical knowledge that fiduciaries could rely on in defending nontraditional investment picks.[42] Courts were soon persuaded, and by the 1990s, a new standard for fiduciary asset management had evolved.[43] The American Law Institute picked up on the new standard, officially naming it the "prudent investor rule," in its *Restatement (Third) of Trusts*, a death knell for the defunct "prudent man rule."[44] Subsequently, the National Conference of Commissioners on Uniform State Laws issued the *Uniform Prudent Investor Act*[45] which has since been adopted in most states.[46]

In its prefatory note, the *Uniform Prudent Investor Act* highlights the following adjustments to prior notions of investment "prudence:"

> (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. UPIA § 2(b).
>
> (2) The tradeoff in all investing between risk and return is identified as the fiduciary's central consideration. UPIA § 2(b).
>
> (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. UPIA § 2(e).
>
> (4) The long familiar requirement that fiduciaries diversify their investments has been integrated into the definition of prudent investing. UPIA § 3.
>
> (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.[47] UPIA § 9.

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42. *Id.*at 269.
43. *Id.*
44. RESTATEMENT (THIRD) OF TRUSTS § 227 (1992).
45. UNIF. PRUDENT INVESTOR ACT, 7B U.L.A. 280-311 (2000).
46. UNIF. PRUDENT INVESTOR ACT, Table of Jurisdictions Wherein Act Has Been Adopted, 7B U.L.A. 280 (2000).
47. UNIF. PRUDENT INVESTOR ACT, Prefatory Note, 7B U.L.A. 282 (2000).

Although Kentucky has not adopted the *Uniform Prudent Investor Act*,[48] the "prudent investor rule" has been incorporated into state law[49] which provides that all banks and corporate fiduciaries in Kentucky must comply with "prudent investor" standards in investing trust and estate assets.[50]

D. *The Uniform Principal and Income Act*

The Uniform Law Commissioners promulgated the first Uniform Principal and Income Act in 1931 in response to fiduciaries seeking guidance in the following four areas of inquiry:

> (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?

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48. Representative Barrows did introduce a version of the Uniform Prudent Investor Act on January 19, 2000, but it did not make it out of committee meetings. H.B. 401, 2000 Reg. Sess. No. 11 (Ky. 2000), *available at* http:// www.lrc.ky.gov/recarch/00rs/hb403.htm>.

49. KY. REV. STAT. ANN. § 286.3-277 (LexisNexis 2004 & Supp. 2006). Note that KRS 287.277 was recently renumbered to KRS 286.3-277. KY. REV. STAT. ANN. § 287.277 (LexisNexis 2004 & Supp. 2006).

KY. REV. STAT. ANN. 286.3-277 states in full:

> 1) Notwithstanding the provisions of any other law, a bank empowered to act as a fiduciary or trust company, when investing, reinvesting, purchasing, acquiring, exchanging, selling, and managing property held in a fiduciary capacity, shall act as a prudent investor would, in light of the purposes, terms, distribution requirements, and other circumstances of the fiduciary account.
>
> 2) The standard described in subsection (1) of this section 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 account portfolio and as part of an overall investment strategy, which should incorporate risk and return objectives reasonably suitable to the account.
>
> 3) In making and implementing investment decisions, the bank or trust company has a duty to diversify the investments of the account unless, under the circumstances, it is prudent not to do so.
>
> 4) In addition, the bank or trust company shall: a) conform to fundamental fiduciary duties of loyalty and impartiality; b) act with prudence in deciding whether and how to delegate authority and in the selection and supervision of agents; and c) incur only costs that are reasonable in amount and appropriate to the investment responsibilities of the account.
>
> 5) The duties of the bank or trust company under this section are subject to the rule that in investing the funds of the account, the bank or trust company: a) has a duty to the beneficiaries of the account to conform to any applicable statutory provisions governing investment by fiduciaries; and b) has the power expressly or impliedly granted by the terms of the account or applicable instrument and has a duty to the beneficiaries of the account to conform to the terms of the account directing or restricting investments by the bank or trust company.

50. *Id*. Individual fiduciaries may elect to have KRS § 286.3-277 apply to them as well pursuant to KRS § 386.454(3); however, it requires approval of the district court. KY. REV. STAT. ANN. § 386.454(3) (LexisNexis 1999 & Supp. 2005).

(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?[51]

The Uniform Law Commission's main focus in addressing these issues under the 1931 Uniform Act was to provide a standardized protocol for fiduciaries administering income and principal interests that would be fair and reasonable to both current and future beneficiaries.[52] This remained their focus in 1964 when the act was revised to account for the introduction of new investment instruments that were not contemplated under the 1931 version of the Uniform Act;[53] however, as already noted, the advent of modern portfolio theory and total return investing made it all but impossible for fiduciaries to remain fair and reasonable.[54] The investment climate of the 1990s simply did not produce adequate income returns, as defined under traditional fiduciary accounting rules;[55] thus, income beneficiaries, feeling slighted by fiduciary investment selections that ostensibly favored remaindermen, began to challenge fiduciaries, questioning their supposed impartiality.[56]

In 1997, the Uniform Law Commission responded by updating the Uniform Act with the specific intention of addressing the outcry by fiduciaries struggling to maintain respectable rates of return, as required by the Uniform Prudent Investor Act, while satisfying their duty of impartiality.[57] The prefatory note of the 1997 Uniform Act offers the following rationale behind its adoption:

> 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

51. *See* UNIF. PRINCIPAL & INCOME ACT (amended 1997), Prefatory Note, 7B U.L.A. 132 (2000). Although, these four questions are presented in the preface to the 1997 Act, they have consistently been the driving purpose behind each version of the Act. *Id*.

52. *See* UNIF. PRINCIPAL & INCOME ACT (amended 1962), Prefatory Note, 7B U.L.A. 242 (2000).

53. *See* UNIF. PRINCIPAL & INCOME ACT (amended 1997), Prefatory Note, 7B U.L.A. 194 (2000). Specifically, "trustees who found it difficult to administer trusts under the older Act due to the development of new forms of investment property for trustees," especially in "corporate distributions and also in the holding of mineral resources as a trust investment." *Id*.

54. *See* DiRusso & Sablone, *supra* note 4, at 262.

55. *See* Wiensch & Beetz, *supra* note 37, at 44.

56. *Id.*.

57. UNIF. PRINCIPAL & INCOME ACT (amended 1997), Prefatory Note, 7B U.L.A. 133 (2000).

> 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* . . . To leave a trustee constrained by the traditional system would inhibit the trustee's ability to fully implement modern portfolio theory.[58]

Kentucky, which had adopted both the 1931 and 1964 versions of the Uniform Act, readily accepted the 1997 version of the Uniform Act, thereby ushering in a new regime of fiduciary asset management.[59]

III. THE KENTUCKY PRINCIPAL AND INCOME ACT

The Kentucky Act is a significant departure from the rules which previously governed fiduciaries[60] in that it seeks to integrate flexibility into principal and income management as a means of accommodating the total return approach to investment.[61] Due to the Kentucky Act's recent passage,[62] there is little binding interpretive precedent on the subject; thus, the ensuing discourse merely surveys key provisions and points out notable distinctions between the Kentucky Act and the Uniform Act.

A. *Survey of Key Provisions*

The Kentucky Act is divided into five substantive articles governing the administrative lifecycle of an income interest in an estate or trust.[63] Article 1 primarily sets forth the duties and powers that a fiduciary has in managing an income interest.[64] Articles 2 and 3 detail the rules for determining income and

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58. *Id*. (emphasis added).

59. Kentucky enacted the 1931 Act on May 18, 1956. KY. REV. STAT. ANN. § 386.330 (West 1963) (repealed January 1, 1993). Later it was repealed on January 1, 1993 with the adoption of the 1962 Act. KY. REV. STAT. ANN. § 386.349 (LexisNexis 1999) (repealed January 1, 2005). The 1962 Act was repealed and the 1997 version of the Uniform Act enacted January 1, 2005. KY. REV. STAT. ANN. § 386.504 (LexisNexis 1999 & Supp. 2005).

60. For a comparison between the old 1962 Kentucky Act and the new 1997 Kentucky Act, see Appendix A. Leigh McKee, Bluegrass Estate Planning Council (Nov. 2004).

61. Walter R. Morris, Jr., *The Kentucky Principal and Income Act*, 69 KY. BENCH & BAR. 5, 5-6 (March 2005).

62. The Kentucky Act became effective January 1, 2005. KY. REV. STAT. ANN. § 386.504 (LexisNexis 1999 & Supp. 2005). Interestingly, the Kentucky Act was first introduced by Representative Barrows on January 19, 2000, but it never ripened into law. H.B. 403, 2000 Reg. Sess. No. 11 (Ky. 2000), *available at* http:// www.lrc.ky.gov/recarch/00rs/hb403.htm>.

63. KY. REV. STAT. ANN. §§ 386.450-386.504 (LexisNexis 1999 & Supp. 2005).

64. KY. REV. STAT. ANN. §§ 386.450-386.454.

apportioning receipts and disbursements between income and principal after a decedent dies, in the case of an estate, or after an income interest in a trust ends.[65] Articles 4 and 5 cover the allocation of receipts and disbursements to income or principal during the administration of an income interest.[66] There is actually a sixth article in the Kentucky Act; however, it merely recites the short title of the act for reference purposes.[67]

1. Article 1 - Definitions and Fiduciary Duties

i. Fiduciary Duties

A fundamental tenet of fiduciary law is strict adherence to the intent of a testator or settlor.[68] Presumably, a valid will or trust document is the purest expression of such intent;[69] thus, the terms of such instruments govern the fiduciary in allocating receipts and disbursements to or between principal and income.[70] Article 1 of the Kentucky Act, acknowledging the primacy of intent, requires fiduciaries to comply with the terms of the governing instrument, whether a will or trust, even if those terms contradict other provisions of the Kentucky Act.[71] Anticipating instances when the governing instrument will be silent on such matters, the Kentucky Act allocates all such receipts or disbursements to principal, a default in the Kentucky Act that seems to favor remaindermen, the presumptive beneficiaries of interests in principal.[72]

Conveniently illustrating the tension inherent in income and principal administration, the very next provision of Article 1 requires, again when the governing instrument is silent, that the fiduciary "administer the trust or estate *impartially*, based on what is fair and reasonable to *all of the beneficiaries*."[73] As previously noted, impartiality is no simple task.[74] A fiduciary must struggle to balance the often competing interests of income beneficiaries and remaindermen, as each has a strong preference as to whether a receipt from an investment lands

65. KY. REV. STAT. ANN. §§ 386.456-386.464.
66. KY. REV. STAT. ANN. §§ 386.466-386.502 (LexisNexis 1999 & Supp. 2005).
67. KY. REV. STAT. ANN. §386.504.
68. Clay v. Crawford, 183 S.W.2d 797, 804 (1944) (stating that "[t]he fundamental rule in the construction of a trust instrument is to ascertain the intent of the parties, particularly of the trustor. That is to be done from the language employed, read in the light of the contemporary circumstances, the object to be accomplished, and all other attendant facts actually or presumably within the knowledge of the parties").
69. Combs v. First Sec. Nat. Bank & Trust Co., 431 S.W.2d 719, 720 (1968).
70. KY. REV. STAT. ANN. § 386.452(1)(a) (LexisNexis 1999 & Supp. 2005).
71. KY. REV. STAT. ANN. § 386.452(2).
72. KY. REV. STAT. ANN. § 386.452(1)(d).
73. KY. REV. STAT. ANN. § 386.452(2) (emphasis added).
74. *See* Gillett & Guzman, *supra* note 2, at 1.

in the "income" account or the "principal" account.[75] Fortunately, the Kentucky Act provides a means for ameliorating such discord.

ii. The Power to Adjust

Under the Kentucky Act, the most helpful tool a fiduciary has in balancing the financial interests of income beneficiaries and remaindermen is the power to adjust receipts and expenses between income and principal.[76] This power is particularly useful in light of the aforementioned ascendance of "total return investing," which rejects the practice of labeling returns as either income or principal and thereby, increases the potential for disproportionate investment yields favoring either the income beneficiaries or remaindermen.[77] With the power of adjustment, a fiduciary can account for such variations on an annual basis by treating a receipt as income that would otherwise have been deemed principal and vice versa.[78] In so doing, the fiduciary can more equitably negotiate tensions between beneficiaries, thereby fulfilling his or her duty of impartiality.[79]

For example, the Kentucky Act allows a fiduciary to invest in assets that yield little income but have the potential for great capital appreciation.[80] Generally, a capital gain dividend is treated as principal, which is not distributable to the income beneficiary.[81] With the power to adjust however, the fiduciary can instead allocate a portion of the principal to income when the fiduciary sees a need to increase the amount of distributable income.[82] In other situations, the fiduciary may allocate a portion of the estate or trust's income to principal.[83] For example, in a period of high inflation, the fiduciary may invest in bonds that provide a high return.[84] To make up for the diminution of principal value attributable to inflation and other factors, the fiduciary may transfer annually a portion of the income that the bonds generate to principal.[85]

It is important to emphasize that the power to adjust does not authorize a fiduciary to increase or decrease a beneficiary's interest in income or principal.[86]

75. DiRusso & Sablone, *supra* note 4, at 262-63.

76. KY. REV. STAT. ANN. § 386.454 (LexisNexis 1999 & Supp. 2005).

77. 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, 53 (1993).

78. KY. REV. STAT. ANN. § 386.454 (LexisNexis 1999 & Supp. 2005).

79. *See* UNI. PRINCIPAL & INCOME ACT § 104 (amended 1997), 7B U.L.A. 141 (2000).

80. The prudent investor rule found in KY. REV. STAT. ANN. § 286.3-277 (LexisNexis 2004 & Supp. 2006) embodies this idea.

81. KY. REV. STAT. ANN. § 386.466(3)(d) (LexisNexis 1999 & Supp. 2005).

82. UNIF. PRINCIPAL & INCOME ACT § 104 cmt., example (1) (amended 1997), 7B U.L.A. 146-47 (2000).

83. *Id.* § 104 cmt., example (2), at 147.

84. *Id*.

85. *Id.*

86. *Id.* § 104 cmt., at 143.

It merely allows the fiduciary to reallocate income and principal when "the income component of a portfolio's total return is too small or too large because" of the fiduciary's investment decisions.[87] The goal is to provide the fiduciary with a means of maximizing overall investment returns while still maintaining its duty of impartiality to all beneficiaries.[88]

a. Requirements to Exercise the Power to Adjust.

Under the Kentucky Act, the following four requirements must be satisfied before a fiduciary can exercise the power to adjust:

(1) The fiduciary must manage assets in accordance with the prudent investor rule, whether by law or election;

(2) The governing instrument must describe the income beneficiary's distribution rights with reference to "income" in the traditional trust accounting sense;

(3) The fiduciary must be unable to administer the assets impartially with respect to all the beneficiaries; and

(4) The adjustment must be approved by District Court.[89]

With regard to the first requirement, in Kentucky the prudent investor rule governs all banks and corporate fiduciaries pursuant to KRS 286.3-277.[90] Individual fiduciaries may elect to have KRS 286.3-277 apply to them as well pursuant to KRS 386.454(1); however, in either case, whether KRS 286.3-277 applies by law or election, the governing instrument must also enable the fiduciary to comply with the principles of prudent investment, *i.e.*, it must not expressly prohibit it.[91] Assuming the governing instrument makes such allowances, there would be no need to adjust between income and principal if the governing instrument did not also associate distributions with its income; thus, the second requirement, noted above, is met if the governing instrument also provides for an income beneficiary of some sort.[92]

As already discussed, standards of prudent investment often result in disproportionate treatment of income beneficiaries and remaindermen from a financial standpoint. Hence, the third requirement that must be met before a fiduciary can adjust between income and principal is that the terms of the governing instrument and principles of prudent investment make it impossible

87. *Id.*
88. *Id.*
89. KY. REV. STAT. ANN. § 386.454(2) (LexisNexis 1999 & Supp. 2005).
90. KY. REV. STAT. ANN. § 286.3-277 (LexisNexis 2004 & Supp. 2006). See *supra* note 49 for the full text of KRS § 286.3-277.
91. KY. REV. STAT. ANN. § 386.454(2) (LexisNexis 1999 & Supp. 2005).
92. *Id.*

for the fiduciary to meet its duty of impartiality to all the beneficiaries.[93] If the fiduciary concludes that it cannot impartially administer the assets on behalf of the beneficiaries, then the fiduciary has satisfied the third requirement.[94]

The Kentucky Act requires one last step before making an adjustment between income and principal.[95] The fiduciary must obtain District Court approval[96] which, as defined by the Kentucky Act, requires the consent of all current beneficiaries and all "remainder beneficiaries in the oldest generation."[97] This requirement of the Kentucky Act differs from the corresponding provisions of the Uniform Act[98] which simply allow the fiduciary to use its own discretion in making adjustments based upon a list of several factors.[99]

Though ostensibly burdensome, the Kentucky Act's fourth requirement does have at least two possible benefits. First, it reduces the potential for disgruntlement among the beneficiaries since they effectively have to consent to

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93. *Id*.

94. *Id*.

95. *Id*.

96. *Id*.

97. KY. REV. STAT. ANN. § 386.450(3) (LexisNexis 1999 & Supp. 2005) (stating that "'District Court approval' means the consent of: (1) All current beneficiaries; (2) All remainder beneficiaries in the oldest generation; and (3) The court"). Questions have been raised as to what constitutes the oldest generation. Bruce K. Dudley, *Kentucky Principal and Income Act, in* PRACTICAL RISK MANAGEMENT FOR TRUSTEES AND OTHER FIDUCIARIES A-4 (Office of Continuing Legal Education, Univ. of Ky. College of Law 2005) (asking "[w]ho are the remainder beneficiaries in the oldest generation" and whether a grandchild counts as the remainder beneficiary in the oldest generation or if it is just the child of the settlor).

98. The corresponding section of the Uniform Act can be found in § 104. UNIF. PRINCIPAL & INCOME ACT § 104 (amended 1997), 7B U.L.A. 141 (2000).

99. The following are factors contained in § 104(b):

> (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; the extent to which they consist of financial assets, interests in closely held enterprises, tangible and intangible personal property, or real property; 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 allocated to income under the other sections of this [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) whether and to what extent the terms of the trust 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 income;
> (8) the actual and anticipated effect of economic conditions on principal and income and effects of inflation and deflation; and
> (9) the anticipated tax consequences of an adjustment.

UNIF. PRINCIPAL & INCOME ACT § 104(b) (amended 1997), 7B U.L.A. 142 (2000).

the adjustment beforehand.[100] Second, it prevents a beneficiary, who is serving as the fiduciary, from self-dealing by strictly prohibiting adjustments under such circumstances.[101] As a practical matter, however, even though the Kentucky Act does not contain the list of considerations referenced under the Uniform Act,[102] a prudent fiduciary should still take them into account when contemplating an adjustment.[103]

Finally, the Kentucky Act also provides a list of specific circumstances when a fiduciary shall not be permitted to make an adjustment, despite having met the other statutory requirements.[104] Generally, these prohibitions are intended to prevent unwanted tax consequences from occurring. For example, the Kentucky Act forbids adjustments that would diminish the income interest of a surviving spouse when an estate may be entitled to a marital deduction with respect to the trust in which the surviving spouse has a terminable interest.[105] A fiduciary may also release the power to adjust, permanently or for a limited period of time, if

100. Morris, *supra* note 61, at 8.

101. KY. REV. STAT. ANN. § 386.454(4)(g) (LexisNexis 1999 & Supp. 2005) (disallowing a trustee to adjust between income and principal when he is also a beneficiary). *But see* KY. REV. STAT. ANN. § 386.454(5) (LexisNexis 1999 & Supp. 2005) (permitting the co-trustee of the beneficiary-trustee to make an adjustment between income and principal unless expressly prohibited by the document).

102. *See supra* note 95 for the list of factors.

103. Morris, *supra* note 61, at 8 (stating that the rationale for the adjustment in consideration of the factors in the Uniform Act may also want to be presented to the district court when asking for approval).

104. KY. REV. STAT. ANN. § 386.454(4) (LexisNexis 1999 & Supp. 2005) states:

> A fiduciary shall not make an adjustment: (a) [t]hat 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 would be allowed, in whole or in part, if the fiduciary did not have the power to make the adjustment; (b) [t]hat 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; (c) [that changes the amount payable to a beneficiary as a fixed annuity or a fixed fraction of the value of the trust assets; (d) [f]rom 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; (e) [i]f possession or exercising the power to make an adjustment causes an individual to be treated as the owner of all or part of the trust or estate for income tax purposes, and the individual would not be treated as the owner if the fiduciary did not possess the power to make an adjustment; (f) [i]f possessing or exercising the power to make an adjustment causes all or part of the trust or estate assets to be included for estate tax purposes in the estate of an individual who has the power to remove a fiduciary, appoint a fiduciary, or both, and the assets would not be included in the estate of the individual if the fiduciary did not possess the power to make an adjustment; (g) [i]f the fiduciary is a beneficiary of the trust of estate; or (h) [i]f the fiduciary is not a beneficiary, but the adjustment would benefit the fiduciary directly or indirectly; except that any effect on the fiduciary's compensation shall not preclude an adjustment so long as the fiduciary's fees are reasonable and otherwise comply with the applicable law.

105. *Id.* at § 386.454(4)(a).

the fiduciary is concerned that holding or exercising the power may impose unwanted tax burdens or cause other tax-related problems.[106]

b. Conversion to Unitrust

Another difference between the Kentucky Act and the Uniform Act is that the Kentucky Act includes, under its power of adjustment provision, the ability to convert to a unitrust payout.[107] This approach effectively allows the fiduciary to define "income" as an annual distribution equal to 3% to 5% of the net fair market value of the trust's assets as determined at the end of the calendar year, regardless of whether such assets would otherwise be considered income or principal as traditionally defined by state law. [108]

By converting to a unitrust payout, a fiduciary can better allocate the benefits of the trust between current and future beneficiaries, thereby, enabling the trustee to satisfy its duty of impartiality while simultaneously investing to maximize total return.[109] A unitrust can also be administratively simpler for the fiduciary because the income beneficiary is entitled to a certain percentage and all beneficiaries generally understand the calculation.[110] Furthermore, because a certain sum can be distributed on a regular basis, a unitrust may allow an income beneficiary to better plan his or her finances.[111]

Although a unitrust approach carries some welcome benefits, at times it can be overly strict and inflexible.[112] For example, if a fiduciary converts to a unitrust payout, the income beneficiary will receive the designated percentage of the assets yearly, an approach that may not allow a trustee to withhold income if circumstances warrant.[113] If the trustee does wish to withhold the unitrust

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106. *Id*. at § 386.454(6).

107. *Id*. at § 386.454(2) (providing in part that that "[a] trustee may adjust between principal and income to the extent . . . the trustee determines after applying the rules in KRS 386.452(1), that the trustee is unable to comply with KRS 386.452(2) and the adjustment, including an adjustment method such as an annual percentage distribution if the percentage is not less than three percent (3%) nor more than five percent (5%) of the fair market value of the trust assets determined annually . . .").

108. *Id.* For a detailed discussion of the procedures used to convert to a unitrust, see Wayne F. Wilson, *Uni-trust Conversion Procedure Under Kentucky's Principal and Income Act*, *in* PRACTICAL RISK MANAGEMENT FOR TRUSTEES AND OTHER FIDUCIARIES C-11 (Office of Continuing Legal Education, Univ. of Ky., College of Law., 2005).

109. Morris, *supra* note 61, at 6. Trustees can also better achieve impartiality if a unitrust is adopted. James P. Teufel, *Beware the Unitrust Conversion*, TRUSTS & ESTATES, Apr. 2003, at 60.

110. *See* Robert B. Wolf, *The Power to Adjust and the Unitrust - The New Uniform Principal and Income Act, Excerpts From Total Return UniTrusts (TRUs), Meeting Human Needs and Investment Goals Through Modern Trust Design*, 1, 18-19, http://www.leimberg.com/freeResources/truArticles/POWERWOLF.DOC. For several resources and articles on the unitrust see http://www.leimberg.com/freeResources/trus.asp.

111. *Id.* A beneficiary could receive a unitrust distribution quarterly or even monthly. *Id*. at 19.

112. Morris, *supra* note 61, at 6.

113. *Id.* This may happen when an income beneficiary does not need the income or receiving the income will create adverse tax consequences. *Id.*

income distribution, the district court must once again approve.[114] Also, there is some uncertainty as to whether a conversion to a unitrust is a taxable event.[115]

2. Article 2 - Decedent's Estate or Terminating Income Interest

Article 2 details the powers and responsibilities of a fiduciary when an income interest in a trust or estate ends.[116] Among those responsibilities, a fiduciary must determine the amount of net income and net principal to be received by a remainder beneficiary.[117] The fiduciary also has the discretion to pay and deduct administration expenses and interest on death taxes from either income or principal;[118] however, death taxes, funeral expenses, and debts must be paid from the principal.[119] Permitting the fiduciary to choose the source of payment for such expenses eliminates the need to adjust between principal and interest 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.[120]

When handling distributions to residuary and remainder beneficiaries, the fiduciary is to pay these beneficiaries the net income earned during the period of administration on the basis of each beneficiary's proportionate interest in the undistributed assets.[121] Determination of proportionate interest is based upon asset values as of the date reasonably near the time of distribution, rather than the "date of death" values.[122]

3. Article 3 - Apportionment at Beginning and End of Income Interest

Article 3 covers the apportionment of receipts and disbursements at the beginning and end of an income interest of a trust or estate.[123] According to Article 3, an income interest begins on the date (1) specified in the trust

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114. *Id.*

115. Teufel, *supra* note 109, at 60.

116. Article 2 consists of KY. REV. STAT. ANN. §§386.456- 386.458 (LexisNexis 1999 & Supp. 2005).

117. KY. REV. STAT. ANN. § 386.456(1).

118. KY. REV. STAT. ANN. § 386.456(2)(b). However, interest on death taxes may be paid from income provided that estate tax marital or charitable deduction will not be affected. UNIF. PRINCIPAL & INCOME ACT § 201(2)(B) cmt. (amended 1997), 7B U.L.A. 152 (2000). Interest on estate and inheritance taxes may be deducted for income tax purposes without having to reduce the estate tax deduction for amounts passing to a charity or surviving spouse, whether the interest is paid from principal to income. *Id*.

119. KY. REV. STAT. ANN. § 386.456(2)(c).

120. Henry C.T. Richmond, III, *Kentucky Principal and Income Act*, in 31ST ANNUAL MIDWEST/MIDSOUTH ESTATE PLANNING INSTITUTE B-12 to -13 (Office of Continuing Legal Education, Univ. of Ky. College of Law 2004).

121. KY. REV. STAT. ANN. § 386.456(4) (LexisNexis 1999 & Supp. 2005).

122. KY. REV. STAT. ANN. § 386.458 (2)(d).

123. KY. REV. STAT. ANN. §§ 386.460 to 386.464 (comprising Article 3 of the Kentucky Act entitled Apportionment at Beginning and End of Income Interest).

document or (2) when an asset becomes "subject to a trust or successive income interest."[124] Likewise, Article 3 provides the end date of an income interest is "[(1)] the day before an income beneficiary dies or [(2)] . . . on the last day of a period during which there is no beneficiary to whom a trustee may distribute income."[125]

Article 3 then sets forth the following rules for apportioning receipts and disbursements when a decedent dies or an income interest begins:[126]

i. Periodic Payments

Periodic receipts such as rents, dividends, interest and annuities, and disbursements such as the interest portion of a mortgage payment, are allocated to principal if they are due but unpaid before an income interest begins or the date a decedent dies.[127]

ii. Nonperiodic Payments

Nonperiodic receipts and disbursements, such as interest on an income tax refund, would be apportioned to principal to the extent it accrues before an income interest begins (or the date a decedent dies) and income if it accrues after the income interest begins (or the date a decedent dies).[128]

iii. Undistributed Income

Generally, an income beneficiary, or the estate of that beneficiary if the income interest terminates upon death, is entitled to "undistributed income," which is "income received before the date on which an income interest ends."[129] If the income beneficiary has the power to revoke more than 5% of the trust; however, the undistributed income attributable to the revocable portion of the trust is apportioned to principal.[130]

The Kentucky Act adds a provision when dealing with charitable beneficiaries which allows a settlor to change the charitable beneficiary prior to the distribution of any undistributed income, "so long as the change does not

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124. KY. REV. STAT. ANN. § 386.460(1). In the case of a testamentary trust, an asset becomes "subject to a trust" on the date of a testator's death; or, in the case of an inter vivos trust, on the date it is transferred to the trust. *Id*. at § 386.460(2).

125. *Id*. at § 386.460(4).

126. *See* KY. REV. STAT. ANN. §§ 386.460 to 386.464.

127. KY. REV. STAT. ANN. § 386.462(2); UNIF. PRINCIPAL & INCOME ACT § 302 (amended 1997), 7B U.L.A. cmt. 156-57 (2000). Thus, this takes on the original common law rule that periodic payments such as rents, dividends, interest, annuities and disbursements are not apportioned. *Id*.

128. KY. REV. STAT. ANN. § 386.462(2). If the due date occurs *after* the date of death, the receipt or disbursement is allocated to income. *Id*.

129. *Id.* at § 386.464(1).

130. *Id*. at § 386.464(2).

alter the income, gift, estate, or other tax benefits available under the terms of the trust."[131]

4. Article 4 - Allocation of Receipts During Administration of Trust

Article 4 provides for the proper allocation between income and principal of assets received during administration.[132] Article 4 can be divided into three parts: (1) receipts from entities, (2) receipts not normally apportioned, and (3) receipts normally apportioned.[133]

i. Receipts from Entities

The Kentucky Act defines "entity" as "a corporation, partnership, limited liability company, regulated investment company, real estate investment trust, common trust fund, or any other organization in which a trustee has an interest other than a trust or estate . . . ."[134] Generally, receipts from entities are allocated to income;[135] however, receipts of the following items are instead allocated to principal: (1) "[p]roperty other than money;"[136] (2) "[m]oney received in one (1) distribution or a series of related distributions in exchange for part or all of a trust's interest in the entity;"[137] (3) "[m]oney received in total or partial liquidation of the entity;"[138] and (4) "[m]oney 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."[139] Also, a trustee shall allocate an income distribution from another trust or estate to income and a principal distribution to principal provided that the other trust or estate does not specify otherwise.[140]

ii. Receipts That Are Not Normally Apportioned

Receipts of the following types of assets are allocated to principal: (1) money "received from the sale, exchange liquidation, or change in form of a principal asset, including stock splits. . . ."[141] (2) "[a]mounts recovered from

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131. *Id.* at § 386.464(3).
132. KY. REV. STAT. ANN. §§ 386.466-386.488 (comprising Article 4 of the Kentucky Act entitled Allocation of Receipts During Administration of Trust).
133. *Id. See also* UNIF. PRINCIPAL & INCOME ACT §§ 401-415 (amended 1997), 7B U.L.A. 161-82 (2000).
134. KY. REV. STAT. ANN. § 386.466(1). Note that a property held in tenancy in common or a joint venture is not included. Richmond, *supra* note 120, at B-16.
135. KY. REV. STAT. ANN. § 386.466(2). A number of exceptions apply where receipts received from an entity are allocated to principal. *Id*. at § 386.466(3).
136. *Id*. at § 386.466(3)(a).
137. *Id*. at § 386.466(3)(b).
138. *Id*. at § 386.466(3)(c).
139. *Id*. at § 386.466(3)(d).
140. KY. REV. STAT. ANN. § 386.468.
141. KY. REV. STAT. ANN. § 386.470(2).

third parties;"[142] (3) "[n]et income received in an accounting period during which there is no beneficiary to whom a trustee may or shall distribute income;"[143] and (4) "options to buy property from the trust."[144] Also, generally, life insurance proceeds or similar contracts that insure trusts assets are allocated to principal.[145] Items that are usually allocated to income include receipts from rental property[146] and any interest received from obligations owed to the trustee.[147]

iii. Receipts That Are Normally Apportioned

Under the Kentucky Act, receipts from deferred compensation, annuities and similar payments are apportioned between income and principal.[148] To the extent that a payment is required to be made, pursuant to the required minimum distribution rules for qualified retirement plans and individual retirement accounts, 10% of any receipts are allocated to income and the balance is allocated to principal.[149] Any other receipts from such plans, including private or commercial annuities, and pension, profit-sharing, stock-bonus, or stock-ownership plans are allocated to principal.[150] Receipts from liquidating assets, such as leasehold interests or patent, copyright and royalty rights, are allocated similarly, with 10% going to income and the rest to principal.[151] Article 4 concludes with detailed rules for the apportionment of receipts from interests in minerals, water, and other natural resources,[152] including timber.[153]

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142. *Id*. at § 386.470(3).
143. *Id*. at § 386.470(5).
144. *Id*. at § 386.470(6).
145. KY. REV. STAT. ANN. § 386.476(1). However, assets received from "a contract that insures the trustee against loss of occupancy or other use by an income beneficiary, loss of income, or loss of profits from a business" are allocated to income. *Id*. at § 386.476(2).
146. KY. REV. STAT. ANN. § 386.472.
147. KY. REV. STAT. ANN. § 386.474(1). The trustee should allocate to principal "any amount received from the sale, redemption, or other disposition of an obligation to pay money to the trustee more than one (1) year after it is purchased or acquired by the trustee . . ." *Id.* at § 386.474(2).
148. KY. REV. STAT. ANN. § 386.480.
149. *Id*. at § 386.480(3). Special rules come into play if the IRA names a QTIP trust as a beneficiary. *See infra* Part IV.C.2 and accompanying text.
150. *Id*. at § 386.480(2) (providing that if a payment is received and it is characterized as income or a dividend, then that payment should be allocated to income).
151. KY. REV. STAT. ANN. § 386.482.
152. KY. REV. STAT. ANN. § 386.484. A rental or lease receipt is allocated to income. *Id*. at § 386.484(1)(a). If money received from a "royalty, shut-in-well payment, take-or-pay payment, [or a] bonus . . . is more than nominal," 90% is allocated to principal and the remaining is allocated to income. *Id.* at § 386.484(1)(c).
153. KY. REV. STAT. ANN. § 386.486 (LexisNexis 1999 & Supp. 2005). Note that "the amount of timber removed from the land that does not exceed the rate of growth of the timber during the accounting periods" should be allocated to income. *Id*. at § 386.486(1)(a). Additionally. if "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," then this is allocated to principal. *Id*. at § 386.486(1)(b).

5. Article 5 - Allocation of Disbursements During Administration of Trust

Article 5 of the Kentucky Act covers the allocation of disbursements between income and principal during administration of an income interest.[154]

i. Disbursements from Income or Principal

Generally, trustee commissions, and investment advisory or custodial services, are paid half from income and half from principal.[155] Fees for accountings, judicial proceedings and other expenditures benefiting both the income and remainder beneficiaries are also divided equally between income and principal.[156] Alternatively, all ordinary expenses incurred in connection with the administration of the trust ("including interest, ordinary repairs, regularly recurring taxes") are paid solely from income,[157] while disbursements related to environmental matters, inheritance taxes, and payments of principal on trust debts are payable from principal.[158]

ii. Adjustments Between Income and Principal

Under Article 5 of the Kentucky Act, a trustee can reimburse principal with receipts otherwise allocable to income if the receipt is "from a principal asset that is subject to depreciation," unless the depreciable property is tangible personal property or real property being used by the beneficiary as a residence.[159] This rule only applies to trusts, not estates, because estates are intended to be open for only a limited period and, as such, remaindermen of an estate are not materially disadvantaged by the impact of depreciation.[160] Article 5 of the Kentucky Act also permits reimbursements from income to principal for such things as: 1) extraordinarily large repairs paid from principal; 2) capital improvements to a principal asset; 3) disbursements made to prepare property for rental; and 4) disbursements for environmental matters pertaining to principal assets.[161]

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154. KY. REV. STAT. ANN. §§ 386.490-386.502 (comprising Article 5 of the Kentucky Act entitled Allocation of Disbursements During Administration of Trust).

155. KY. REV. STAT. ANN. § 386.490(1).

156. *Id*. at § 386.490(2).

157. *Id*. at § 386.490(3).

158. KY. REV. STAT. ANN. § 386.492.

159. KY. REV. STAT. ANN. § 386.494(2).

160. *Id*. at § 386.494(2)(b).

161. KY. REV. STAT. ANN. § 386.496(2). This includes:

> (a) [a]n amount chargeable to income but paid from principal because it is unusually large, including extraordinary repairs; (b) [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; (c) [d]isbursements made to prepare property for rental, including tenant allowances, leasehold improvements, and broker's commissions; (d) [p]eriodic payments on an obligation secured by a principal asset to the extent that the amount transferred

Article 5 of the Kentucky Act also deals with income taxes, and adjustments to be made between income and principal as a result of payment of those taxes.[162] Generally, a trustee must pay income tax on receipts allocated to income from income and must pay tax on receipts allocated to principal from principal, including payment of taxes passed through from an entity, such as a partnership.[163] When the respective tax liabilities of the income beneficiary and remaindermen are imbalanced, the Kentucky Act allows the trustee to make adjustments, with District Court approval, between income and principal to help balance their burdens.[164]

IV. TAX IMPLICATIONS

As discussed above, Kentucky and other states that have adopted the Uniform Act provide the fiduciary with significant leeway in defining "income" in various administrative contexts. To keep up with changing state law notions of what constitutes "income," the IRS revised its definition of "income" for tax purposes to provide guidance to fiduciaries on the tax ramifications of their allocations and apportionments.[165] Finalized on December 31, 2003, these "Final Regulations"[166] generally apply to trusts and estates for tax years ending after January 2, 2004.[167]

A. *Definition of Income*

Traditional notions of income and principal for fiduciary accounting purposes are still respected under the Final Regulations; thus, dividends, interest,

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from income to principal for depreciation is less than the periodic payments; and (e) [d]isbursements described in KRS 386.492(1)(g).

162. KY. REV. STAT. ANN. § 386.498.

163. *Id*.

164. KY. REV. STAT. ANN. § 386.500(1).

165. I.R.C. § 643(b) (West 2000). The definition of income "is intended to be consistent with traditional fiduciary accounting principals." Leigh McKee, *Kentucky Principal & Income Act & Related Final Regulations*, Bluegrass Estate Planning Council Meeting (Nov. 2004). I.R.C. § 643 distinguishes income from distributable net income (DNI). I.R.C. § 643(a), (b) (West 2000). DNI is "used to determine how much of an amount paid, credited, or required to be distributed to a beneficiary will be includible in his gross income." Treas. Reg. § 1.643 (a)-0 (2006). Specifically, DNI "is the taxable income of the trust modified by generally excluding dividend distributions, personal exemptions, capital gains and losses, extraordinary dividends and taxable stock dividends, and including tax exempt interest." IRS, *Glossary of Trust Terms*, http://www.irs.gov/businesses/small/article/0,,id=106554.00.html (last visited February 1, 2007). In other words, DNI is net income modified by the rules under IRC § 643 and distributed to beneficiaries. Suzanne Baillie Schmitt, *Practice Alert: IRS Revises the Definition of Trust Income to Reflect Changing State Law Concepts*, ESTATE PLANNER'S ALERT, Apr. 2004, at 5. This is the income the beneficiary claims as gross income on his personal income tax return. *Id*. If the income is not included in the DNI, then it is taxed to the trust. *Id*.

166. Treas. Reg. § 1.643(b)-1 (2006).

167. *Id*. However, a trust which defines income not consistent with IRC § 643 or the Kentucky Act will not be given favorable tax treatment. McKee, *supra* note 163.

and rents, will generally be allocated to income and proceeds from the sale or exchange of trust assets, *i.e.*, capital gains, will be allocated to principal.[168] However, the Final Regulations now accept state law variations of these general allocation rules so long as the state law changes maintain a "reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year . . . ."[169] Under the Final Regulations, such "reasonable apportionments" include:

> (1) A unitrust amount of no less than 3 %, and no more than 5 %, of the trust's fair market value, whether that value is determined each year or averaged on a multiple year basis; and
>
> (2) Any adjustments between income and principal that are needed to fulfill the fiduciary's duty of impartiality between the income and remainder beneficiaries.[170]

Accordingly, under the Kentucky Act, a fiduciary's conversion of a beneficiary's "all income" interest to a 3% to 5% unitrust payout or reasonable adjustment between income and principal to maintain impartiality among income and remaindermen will be considered a "reasonable apportionment" of a trust's total return and will, thereby, be respected by the IRS for fiduciary accounting purposes.[171]

The Final Regulations also describe the rules for switching between methods of distributing income.[172] If the fiduciary complies "with all requirements of the state statute for switching methods," and if the methods are authorized by state statute, then the switch does not constitute "a recognition event for [income tax] purposes . . . and will not result in a taxable gift from the trust's grantor or any of the trust's beneficiaries."[173]

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168. Treas. Reg. § 1.643(b)-1 (2006).

169. *Id.* This section provides that:

> [A]n allocation of amounts between income and principal pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, including ordinary and tax-exempt income, capital gains, and appreciation.

Also note that a state statute that permits the trustee to make adjustments between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries is generally a reasonable apportionment of the total return of the trust. *Id.*

170. McKee, *supra* note 165.

171. KY. REV. STAT. ANN. § 386.454 (LexisNexis 1999 & Supp. 2005); Morris, *supra* note 61, at 7.

172. Treas. Reg. § 1.643(b)-1 (2006).

173. *Id.*

B. *Treatment of Capital Gains*

As a general rule, capital gains and losses are allocated to principal for fiduciary accounting purposes;[174] thus, the remainder beneficiaries of a trust or the residuary beneficiaries of an estate usually pay tax on net gains for Federal tax purposes.[175] There are, however, exceptions to this general rule if the terms of the governing instrument and applicable local law provide otherwise, or if the fiduciary decides otherwise pursuant to a reasonable and impartial exercise of its discretion (in accordance with the governing instrument and applicable local law). When such conditions are met, capital gains may be allocated to distributable net income ("DNI")[176] for Federal tax purposes in the following three situations:[177]

> (1) When the fiduciary allocates the gains to income and treats them as such for fiduciary accounting purposes; [178]
>
> (2) When the fiduciary allocates the gains to principal but, for fiduciary accounting purposes, consistently treats the gains as having been distributed to income beneficiaries during the taxable year; [179] or
>
> (3) When the fiduciary allocates the gains to principal but actually distributes the gains to income beneficiaries or uses the gains to determine the amount that is distributed or required to be distributed to a beneficiary.[180]

There are fourteen examples in the Final Regulations that illustrate these three situations in which capital gains can be allocated to DNI, all of which emphasize the importance of a fiduciary's consistency in handling the allocations after the first year in which such treatment commenced.[181]

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174. KY. REV. STAT. ANN. § 386.470(2) (LexisNexis 1999 & Supp. 2005).
175. Morris, *supra* note 61, at 7.
176. Treas. Reg. § 1.643(a)-0 (2006). This section provides that:

> [DNI] limits the deductions allowable to estates and trusts for amounts paid, credited, or required to be distributed to beneficiaries and is used to determine how much of an amount paid, credited, or required to be distributed to a beneficiary will be includible in his gross income. It is also used to determine the character of distributions to the beneficiaries.

Id.

177. Treas. Reg. § 1.643(a)-3(b) (2006).
178. Treas. Reg. § 1.643(a)-3(b)(1).
179. Treas. Reg. § 1.643(a)-3(b)(2).
180. Treas. Reg. § 1.643(a)-3(b)(3). Note that this exception requires that the capital gains actually be distributed, requiring a tracing of the actual capital gains realized. *Id*.
181. Treas. Reg. § 1.643(a)-3 (2006).

C. *Impact on Various Types of Trusts*

1. Marital Deduction Trusts

i. Qualified Terminable Interest Trusts

If the assets of a trust are to qualify for the federal estate tax marital deduction as qualified terminal interest property ("QTIP"), (1) the surviving spouse must be entitled to all of the income from the trust for life and (2) no person can have the power to appoint the property to anyone other than the surviving spouse.[182] The Final Regulations provide that a surviving spouse's interest in a trust meets the income requirement if the governing instrument and applicable local law provide the surviving spouse with a "reasonable apportionment" of the trust's total return for the year.[183] Thus, a spouse who, as the income beneficiary, is entitled to a unitrust amount between 3% and 5%, as provided under the Kentucky Act, is deemed to be entitled to all the income for purposes of qualifying the trust for the estate and gift tax marital deduction.[184]

The Final Regulations also clarify that the power of a trustee to adjust between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries will not be considered a power to appoint trust property to a person other than the surviving spouse and will not disqualify the trust from satisfying the second prong of the QTIP marital deduction requirements.[185]

2. IRA Payable to a QTIP Trust

When an individual retirement account ("IRA") or similar defined contribution plan[186] is payable to a QTIP trust as beneficiary, the IRS views the IRA and the trust itself as two separate items of QTIP; thus, all the income from the trust and the IRA must be distributed to the surviving spouse for life in accordance with the aforementioned QTIP requirements.[187] In Revenue Ruling 2006-26, the IRS clarifies that, under the Final Regulations, the "all income" requirement for QTIP treatment is satisfied if the surviving spouse is entitled to the entire IRA's internal investment income or a 3% to 5% "unitrust" payout of the IRA's total assets on an annual basis.[188]

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182. Treas. Reg. §§ 20.2056(b)-5(a)(1); 25.2523(e)-1(f)(1) (2006).
183. Treas. Reg. § 20.2056(b)-5(f)(1).
184. Treas. Reg. § 1.643(b)-1.
185. Treas. Reg. §§ 20.2056(b)-5(a)(1); 25.2523(e)-1(f)(1).
186. *See* I.R.C. § 4974(c) (West 2000) for a list of retirement plans which are affected by Rev. Rul. 2006-26.
187. *See* Rev. Rul. 2006-26, 2006-22 I.R.B. 939.
188. *Id.*

Revenue Ruling 2006-26, outlining three situations in which a QTIP trust is named as a beneficiary of an IRA, is careful to distinguish between a trustee's allocation of receipts from an IRA pursuant to state law and the qualification of an IRA for QTIP treatment under the Internal Revenue Code.[189] With regard to the allocation of trust receipts, section 409 of the Uniform Act (and the corresponding section 16 of the Kentucky Act) directs a trustee to allocate 10% of any "required" distributions from an IRA to trust income and 90% to trust principal.[190] All other distributions from IRAs are completely allocable to principal.[191] In seeking to qualify the IRA for QTIP treatment, however, the "10 percent rule" of the Uniform Act (and Kentucky Act) has no bearing as it is an administrative rule for trustees seeking to allocate trust receipts.[192] Hence, reliance on the "10 percent rule" for tax purposes would jeopardize the marital deduction.[193]

3. Generation-Skipping Transfer Tax Trusts

Trusts that were irrevocable on or before September 25, 1985 are generally exempt from the generation-skipping transfer ("GST") tax.[194] As such, these "grandfathered" trusts can make distributions to individuals that are two or more generations below the original transferor without incurring GST tax liability.[195] With the widespread adoption of the Uniform Act, however, some practitioners questioned whether a trustee's conversion to a unitrust payout or adjustment between income and principal would cause a "grandfathered" trust to lose its GST tax exempt status.[196]

The Final Regulations make clear that such trusts will remain exempt from GST tax as long as the "applicable local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and meets the requirements of § 1.643(b)-1 . . . ."[197] As noted above, the provisions of the Kentucky Act are within the "reasonable apportionment" requirement; thus, a trustee of a "grandfathered" trust duly exercising its powers under the Kentucky Act will not risk the trust's GST tax-exempt status.[198]

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189. *Id*.

190. UNIF. PRINCIPAL & INCOME ACT § 409 (amended 1997), 7B U.L.A. 170 (2000); KY. REV. STAT. ANN. § 386.480(3) (LexisNexis 1999 & Supp. 2005).

191. *Id.*

192. Natalie Choate, *IRS Rejects UPIA 10 Percent Rule,* TRUSTS & ESTATES, July 2004, at 19.

193. *Id*. A trust may have to be amended if it only specifies that the spouse is entitled to all the income of the trust, but fails to mention income of the IRA. *Id.*

194. Treas. Reg. § 26.2601-1 (2006).

195. *Id*.

196. *Changes to the Income Tax Definition of "Income,"* Tax Management: Estates, Gifts, and Trusts Portfolios: Trustee Investments (BNA) No. 861, at A-54 (January 10, 2005).

197. Treas. Reg. § 26.2601-1(b)(4)(i)(D)(2).

198. *Id*.

4. Charitable Remainder Trusts

The Final Regulations provide that income of a charitable remainder unitrust ("CRUT") "may not be determined by reference to a fixed percentage of the annual fair market value of the trust property."[199] The rationale for this provision is that the unitrust amount of a CRUT cannot be less than 5% of the value of the trust assets;[200] thus, a state law permitting a lower unitrust payout runs afoul of this requirement on its face. In addition, the Final Regulations provide that proceeds from the sale or exchange of any assets contributed to a CRUT by its grantor or from the sale or exchange of any assets purchased by a CRUT "must be allocated to principal and not to trust income at least to the extent" of the fair market value of the assets on the date of their contribution or the purchase price of those assets.[201] Otherwise, proceeds from the sale or exchange of any assets may be allocated to income under the governing instrument, if not prohibited by local law.[202]

V. CONCLUSION

It is nearly impossible for a fiduciary to satisfy completely the demands of income beneficiaries and remaindermen when each is ultimately vying for a greater share of the same property. Clearly, a sound grasp of the key provisions of the Uniform Act and the history behind them will aid fiduciaries feeling hamstrung by their obligations to these beneficiaries. The Kentucky Act, though effectively the same as the Uniform Act, contains a few significant operational departures, chief among them the requirement for District Court approval in matters left to the fiduciary's discretion under the Uniform Act. Regardless, the Uniform Act and its state law counterparts, like the Kentucky Act, are a significant improvement from the inconsistencies and uncertainties of prior law, allowing fiduciaries to serve the best interests of the beneficiaries that depend on them.[203]

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199. Treas. Reg. § 1.664-3(a)(1)(i)(b)(3) (2006).
200. *Id.*
201. *Id.*
202. *Id.*
203. The coauthors gratefully acknowledge the thoughtful guidance of Leigh McKee and Henry C.T. (Tip) Richmond III in researching and writing this article.

Appendix A

Kentucky Principal and Income Act
Comparison of Provisions prior to January 1, 2005 with Provisions after December 31, 2004

Income Item	Old Act		New Act	
	Income	Principal	Income	Principal
Rent	Rent, including sums for cancellation or renewal.		Rent, including sums for cancellation or renewal.	Refundable deposits held subject to terms of lease until lease terms are satisfied.
Interest	Interest on loans, including prepayment penalties	No provision for premium amortization.	Interest, including prepayment penalties; no provision for premium amortization.	
Discount Obligations (e.g., T-bills, savings bonds, zero-coupon bonds, discount bonds, inflation indexed bonds	Some allocation of discount and tax on OID to income.		Proceeds from sale, redemption, etc of bonds that mature within 1 year of purchase or acquisition by trustee, to the extent the proceeds exceed cost/value at time of acquisition.	Proceeds from sale, redemption, etc of debt received more than 1 year after acquisition by trustee.
Natural resources other than timber				
Delay/annual rentals	Income		Income - nominal amounts only.	
Production payments	Income to the extent of any interest factor. Remainder after principal allocation.	Non-interest portion of the payment times unrecovered costs divided by balance owed on the production payment.	Income to the extent of any interest factor.	Remainder.
Royalties, working interests, net profit interests	Remainder	Depletion allowance based on tax depletion, but not in excess of 50%.	10% - includes delay/annual rentals that are more than nominal	90% - includes delay/annual rentals that are more than nominal
Renewable water			Income	
Proceeds from dispositions			Allocated in same manner as receipts.	
			Income and principal from mineral interests owned on 1/1/2005 may be allocated under new law or prior law. Interests acquired after 1/1/2005 allocated based on new law.	
Timber	Allocation to be reasonable and equitable		To the extent that timber removed does not exceed growth.	To the extent that timber removed exceeds growth or receipts from sale of standing timber.
Other liquidating property - e.g., leaseholds, patents, copyrights, etc.	Receipts from the property not in excess of 5% per year of its inventory value - KRS 386.285 - Other depletable property - refers specifically only to deferred comp.	Remaining amount.	10% of receipts.	Remaining amount.
Entities	Dividends - corporations only	Proceeds from sale, call, merger, reorg, total or partial liquidation, stock dividends, stock splits - corporations only.	Money received, generally. Tax on liquidating distributions due from trustee or beneficiary.	Property other than money. Liquidating distributions (including when the distribution is greater than 20% of the entity's gross assets).
Capital gain dividends from RICs and REITs	Ordinary income	All other distributions	All other distributions.	Capital gain dividends.
Receipts from sale of unproductive property	Special allocation.		Spouse may require trust assets to be productive if a marital deduction was allowed.	Otherwise, principal.
Granting an option				Option proceeds.
Deferred comp. annuities, retirement plans				
If some part of the payment is characterized as interest or dividends.	Receipts from the property not in excess of 5% per year of its inventory value.	Remaining amount.	Amounts characterized as interest or dividends.	Amounts other than those characterized as interest or dividends.
If no part of the payment is characterized as interest or dividends.			10% of the amount required to be paid. If necessary to obtain the marital deduction, the additional amount so required.	Remaining amount.