



Office of the State Bank Commissioner

Regulatory Mailing

RM2002-4

TO: All Trust Companies and State-Chartered Banks with Trust Departments
FROM: Franklin W. Nelson, Bank Commissioner
DATE: April 29, 2002
RE: The Revised Uniform Principal and Income Act: Adjustments, Allocations & Disbursements

Background

The National Conference of Commissioners on Uniform State Laws (NCCUSL) enacted the Uniform Principal and Income Act in 1913 with a revision in 1962. The NCCUSL recommended a major revision in 1997 with two primary objectives: (1) to update earlier versions of the Act; and (2) to add new provisions to give trustees greater freedom to make investments pursuant to the Uniform Prudent Investor Act, K.S.A. 58-24a01 et seq. The Kansas legislature enacted the 1997 version of the Uniform Principal and Income Act (Act), with an effective date of July 1, 2000. The Act controls all trusts and decedent's estates in Kansas unless the terms of the will or trust state otherwise.

After reviewing the Uniform Principal and Income Act and fielding questions from Kansas trust officers, the following sections of the Act were identified as requiring supervisory guidance.

Adjustment Powers

Modern portfolio theory has been gaining acceptance in recent years and led the Kansas Legislature to adopt The Uniform Prudent Investor Act (UPIA), K.S.A. 58-24a01 et seq., in July of 2000. The UPIA incorporated the tenets of modern portfolio theory by shifting the focus away from individual investments to the more modern approach of looking at the portfolio as a whole. K.S.A. 58-9-104 is the section of the Uniform Principal and Income Act that allows the trustee to treat income and remainder beneficiaries fairly using the investment tenets of modern portfolio theory that seek total return. The Uniform Principal and Income Act allows the trustee to adjust income and principal to the extent necessary when strict allocation requirements of the Act may provide inequities. A trustee may exercise the power to adjust between income and principal if:

- (1) the trustee invests and manages trust assets in accordance with prudent investor rules;
- (2) the trust agreement describes the amount that may or must be distributed to an income beneficiary by referring to the trust's income;
- (3) the trustee is unable, without exercising the power to adjust, to administer the trust impartially or achieve a degree of partiality required by the governing instrument.

Further, the Uniform Principal and Income Act provides an express list of factors a trustee shall consider, that includes but is not limited to:

- (1) nature, purpose and expected duration of the trust;
- (2) intent of the settlor;
- (3) identity and circumstances of the beneficiary;
- (4) needs for liquidity, regularity of income, and preservation and appreciation of capital; and
- (5) anticipated tax consequences of an adjustment.

Also, the Act provides for express circumstances in which the trustee should not exercise his power to adjust between income and principal. A list of those circumstances includes but is not limited to the following:

- (1) where an adjustment would diminish the income interest of a spouse in a trust for which a QTIP election is made;
- (2) where an adjustment would reduce the actuarial value of the income interest in a trust to which a person transfers property with the intent to qualify for the gift tax exclusion;
- (3) where an adjustment would change the amount payable to the current beneficiary under a private or charitable annuity trust; and
- (4) in cases where the trustee is beneficiary of the trust; or, if not a beneficiary, where the adjustment would benefit the trustee directly or indirectly.

Examination Guidance:

If a trustee makes a principal and/or income adjustment, all relevant factors required by K.S.A. 58-9-104 should be documented in the Board or Trust Committee minutes, for review by examiners.

Allocation to Principal or Income

K.S.A. 58-9-401 through 58-9-415 introduce new rules that change the way trustees will make allocations of trust receipts. K.S.A. 58-9-401 broadens the category from receipts from a corporation to receipts from an "entity" that includes corporations, partnerships, limited liability companies, regulated investment companies, real estate investment trusts, common trust funds, and other similar entities.

K.S.A. 58-9-401 generally follows a simple rule: any "money" received by a fiduciary is regarded as income, and receipts other than money are allocated to principal if they fit certain categories. For example, money received from an investment company (mutual fund) that labels a distribution as a capital gain, should be allocated to principal. Also, property received that is not money, such as a stock distribution, should be allocated to principal. Further, money received as part of a liquidation of an entity would be allocated to principal, and the Act clarifies what is a partial or complete liquidation of an entity.

Examination Guidance:

Apparently, allocations to principal or income under the new Act have not posed a problem for trust departments/companies. However, if misallocations have occurred they should be handled in the same manner as K.S.A. 58-9-501 and 58-9-502 concerns, which are discussed later in this regulatory mailing.

Accounting Treatment

K.S.A. 58-9-403 indicates a trustee who conducts a business held in trust and determines that it is in the best interest of all beneficiaries, may account separately for the business instead of accounting for it as part of the trust's general accounting records. Also, the trustee may allocate net cash receipts to "working capital, the acquisition or replacement of fixed assets, and other reasonably foreseeable needs of the business or activity, and the extent to which the remaining net cash receipts are accounted for as principal or income in the trusts' general accounting records".

Activities for which a trustee may maintain separate accounting records includes but is not limited to:

- (1) farming;
- (2) raising and selling of livestock and other animals;
- (3) management of rental properties; and
- (4) extraction of minerals and other natural resources.

Examination Guidance:

A question will be added to the packet of information received by the bank or trust company during the prenotification process of a pending examination, requesting that the entity identify whether it is maintaining separate accounting records pursuant to K.S.A. 58-9-403.

Mineral Interests/Natural Resources Allocations

K.S.A. 58-9-411 is a marked departure from the 1962 Act and K.S.A. 58-909(a)(3) which required 22% of the gross receipts from natural resources, but not to exceed 50% of the net receipts remaining after the payment of all expenses, direct or indirect, to be allocated to principal as a depletion allowance. The revised Act now states that payments from depleting assets, such as a royalty payment, are subject to the payment being allocated 10% to income and 90% to principal. However, if a trust owns an interest in minerals on the effective date of this Act (which for Kansas, was July 1, 2000), the trustee may allocate receipts from the interest as provided by the Act or in a manner used by the trustee before the effective date of the Act. If the trust acquires an interest in minerals after the effective date of this Act, the trustee is required to allocate the receipts as required by the Act.

Examination Guidance:

Examiners will review mineral interests and apply the old depletion allowance of 22% to all mineral interests acquired before July 1, 2000, unless management chooses to utilize the 90% depletion allowance. Mineral interests placed in trust after July 1, 2000 will be reviewed using the 90% depletion allowance.

Disbursements from Income and Principal

K.S.A. 58-9-501 and 58-9-502 concern the allocation of disbursements during the administration of the trust between income and principal. As in the 1962 Act, ordinary expenses incurred in the administration of the trust such as interest, ordinary repairs and regularly recurring taxes are assessed against income. However, now one-half of trustee, investment advisory and custodial fees, and expenses for accounting and judicial proceedings that involve both income and remainder interests are required to be charged to income, with the other one-half charged to principal. Also, estate, inheritance and other transfer taxes apportioned to the trust are taken out of principal. And in a new provision, environmental expenses, such as those to assess or remove environmental contamination from trust property, are required to be allocated to principal.

Examination Guidance:

Trust departments and trust companies should have adhered to the income and principal disbursement rules since the effective date of the Act in Kansas, which was July 1, 2000. If after a review of transactions, a trust department or trust company finds several transactions have not followed K.S.A. 58-9-501 and 58-9-502, examiners will recommend the Board of Directors decide if the transactions that did not adhere to the new disbursement rules pose a significant risk to the department/company. If the risk is determined to be significant, the department/company should correct the subject transactions and document such in the Board or Trust Committee minutes. Or, if the risk is determined to be minimal, the rationale for not correcting the transactions should be documented in the Board or Trust Committee minutes.