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Managing Assets: The Oklahoma Uniform Principal and Income Act

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MANAGING ASSETS: THE OKLAHOMA UNIFORM PRINCIPAL AND INCOME ACT

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I. Introduction

A trust is the severance of legal and equitable title to certain property, permitting the trustee to manage and invest those assets on behalf of the trust's beneficiaries. The classic trust further splits the equitable interests into two subcategories: (1) income beneficiaries, who receive the income stream generated by the trust for some time period, and (2) remainder beneficiaries, who thereafter acquire the existing principal. Therein lies the tension. Interpersonal relationships aside, income beneficiaries generally prefer income-maximizing investment strategies, while remainder beneficiaries are more concerned with the preservation of the res and the harmful effects of inflation on the investment portfolio. Similarly, each beneficiary class presumably hopes that trust receipts be credited to its side of the ledger while expenditures be charged against the other. Most such determinations are left neither to chance nor whim, but to statute.

In 1998, Oklahoma was the first state to adopt the 1997 version of the Uniform Principal and Income Act (OUPIA), which resolves most such

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accounting questions.[1] The Act, which updates two prior uniform schemes, generally applies to all trusts and estates existing on November 1, 1998, except as otherwise expressly provided in the controlling document.[2]

The drafters of the Uniform Act stated two primary reasons for the 1997 revision.[3] First, they sought to update the provisions of the 1931 Uniform Principal and Income Act and the 1962 Revised Uniform Principal and Income Act[4] and, in so doing, to facilitate the already widespread use of revocable trust agreements as will substitutes.[5] Second, the drafters viewed the revisions as supporting the transition to an investment approach based on principles embodied in the Uniform Prudent Investor Act, which Oklahoma enacted in 1995.[6] That piece of legislation recognizes the income/remainder tension by encouraging investment for total return rather than for a certain level of income as defined by interest, dividends, rent, and other historic income classifications.[7]

Aside from the more global precipitators for the overhaul, the Act's drafters identified four key issues embraced within it and its predecessors: (1) the proper income/principal allocation of a trust res when an income interest begins; (2) the proper income/principal allocation of receipts and disbursements throughout the duration of the income interest; (3) the proper distribution of income received but not yet distributed, due but not yet collected, or accrued but not yet due when the income interest ends; and (4) the proper distribution of income earned during the probate of an estate to trusts and to beneficiaries of specific bequests, pecuniary gifts, and the residue.[8] As detailed in its prefatory note, the 1997 Act responds to those issues, and their often suboptimal statutory or common law response, through change, clarification,[9] or new enactment.[10]

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1. *See* 60 OKLA. STAT. §§ 175.101-175.602 (2001). In 1941, Oklahoma enacted the Uniform Trusts Act (1937), Oklahoma Trust Act, ch. 4, 1941 Okla. Sess. Laws 250, which included the 1931 version of the Uniform Principal and Income Act. *See* 60 OKLA. STAT. §§ 175.26-175.36 (1991). The Oklahoma legislature repealed the 1931 Uniform Principal and Income Act provisions in conjunction with its enactment of the 1998 legislation. Oklahoma Uniform Principal & Income Act, 1998, ch. 115, § 33, 1998 Okla. Sess. Laws 346.

2. 60 OKLA. STAT. § 175.602 (2001).

3. UNIF. PRINCIPAL & INCOME ACT prefatory note (amended 1997), 7B U.L.A. 132 (2000).

4. Oklahoma never enacted the 1962 revision to the 1931 Act.

5. UNIF. PRINCIPAL & INCOME ACT prefatory note (amended 1997), 7B U.L.A. 132 (2000).

6. Oklahoma Uniform Prudent Investor Act, ch. 351, 1995 Okla. Sess. Laws 1841 (codified at 60 OKLA. STAT. §§ 175.60-175.72 (2001)).

7. UNIF. PRINCIPAL & INCOME ACT prefatory note (amended 1997), 7B U.L.A. 132 (2000).

8. *Id.*

9. Changes and/or clarifications include:

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

income. Section 303.

(2) Income from a partnership is based on actual distributions from the partnership, in the same manner as corporate distributions. Section 401.

(3) Distributions from corporations and partnerships that exceed 20% of the entity's gross assets will be principal whether or not intended by the entity to be a partial liquidation. Section 401(d)(2).

(4) Deferred compensation is dealt with in greater detail in a separate section. Section 409.

(5) The 1962 Act rule for "property subject to depletion," (patents, copyrights, royalties, and the like), which provides that a trustee may allocate up to 5% of the asset's inventory value to income and the balance to principal, is replaced by a rule that allocates 90% of the amounts received to principal and the balance to income. Section 410.

(6) The Act changes the percentage used to allocate amounts received from oil and gas; 90% of those receipts are allocated to principal and the balance to income. Section 411.

(7) The Act eliminates the unproductive property rule for trusts other than marital deduction trusts. Section 413.

(8) Charging depreciation against income is no longer mandatory, and is left to the discretion of the trustee. Section 503.

Id. at 133.

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

(1) The application of the probate administration rules to revocable living trusts after the settlor's death and to other terminating trusts. Articles 2 and 3.

(2) The payment of interest or some other amount on the delayed payment of an outright pecuniary gift that is made pursuant to a trust agreement instead of a will when the agreement or state law does not provide for such a payment. Section 201(3).

(3) The allocation of net income from partnership interests acquired by the trustee other than from a decedent (the old Acts deal only with partnership interests acquired from a decedent). Section 401.

(4) An "unincorporated entity" concept is introduced to deal with businesses operated by a trustee, including farming and livestock operations, and investment activities in rental real estate, natural resources, timber, and derivatives. Section 403.

(5) The allocation of receipts from discount obligations such as zero-coupon bonds. Section 406(b).

(6) The allocation of net income from harvesting and selling timber between principal and income. Section 412.

(7) The allocation between principal and income of receipts from derivatives, options, and asset-backed securities. Sections 414 and 415.

(8) Disbursements made because of environmental laws. Section 502(a)(7).

(9) Income tax obligations resulting from the ownership of S corporation stock and interests in partnerships. Section 505.

(10) The power to make adjustments between principal and income to correct inequities caused by tax elections or peculiarities in the way the fiduciary income tax rules apply. Section 506.

Irrespective of one's view of the Act's merits or ability to meet its own stated goals, the substantial changes wrought by its 1997 incarnation demand practitioners' attention. To that end, this Article comprehensively presents the Act as adopted and applied in this state. Due to the Act's recent Oklahoma vintage, there is little binding interpretive precedent, and the following exploration is largely based on its provisions, commentary, and interpretations of earlier Acts or similar provisions in other jurisdictions.

II. The Ground Rules

A. Overriding Application: Managing Assets Outside of the Act

1. Dividing Control Between the Settlor and the Act

The primary goal in interpreting and enforcing the terms of a trust is to effect the settlor's expressed intent,[11] as ascertained from the trust instrument itself where it is free from ambiguity.[12] Settlor intent retains priority under the OUPIA, and can even trump its provisions. When? The statutory analysis is tortuous, and the Act's turn of phrase unfortunate. Rather than succinctly stating that the trust document controls in all matters subject to its provisions, as the pre-1998 Act had indicated,[13] the OUPIA provides the following guidance regarding the effect of contradictory language in the trust instrument or will:

> In allocating receipts and disbursements to or between principal and income, and with respect to any matter within the scope of Articles 2 and 3 of this act, a fiduciary . . . [s]hall administer a trust or estate in accordance with the terms of the trust or the will, even if there is a different provision in this act . . . .[14]

The OUPIA has six distinct articles.[15] Articles 2 and 3 expressly fall within the ambit of the above-quoted provision; Articles 4 and 5, dealing principally with the allocation of receipts and disbursements between income and principal, inferentially so. But the provision implies that Articles 4 and 5 cover matters *other than* receipt and disbursement allocation and that those

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Id. at 132-33.

11. *See, e.g.*, Crowell v. Shelton, 1997 OK 135, ¶ 7, 948 P.2d 313, 315; *In re* Testamentary Trust of Dimick, 1975 OK 10, ¶ 10, 531 P.2d 1027, 1030; Hurst v. Kravis, 1958 OK 290, ¶ 13, 333 P.2d 314, 318.

12. *See, e.g.*, *Crowell*, ¶ 7, 948 P.2d at 315; *In re* Home-Stake Prod. Co. Deferred Comp. Trust, 1979 OK 81, ¶ 8, 598 P.2d 1193, 1196; *Dimick*, ¶ 10, 531 P.2d at 1030.

13. 60 OKLA. STAT. § 175.26 (1991).

14. 60 OKLA. STAT. § 175.103(A) (2001).

15. Articles 1 and 6 are principally definitional and administrative.

provisions control over conflicting language in the governing instrument. This interpretation is possible but unlikely. First, there is a strong argument that all of Articles 4 and 5 relate, whether directly or indirectly, to the allocation of receipts and disbursements between income and principal. Second, courts understandably would hesitate to hold that a settlor's clearly expressed intent would give way to any portion of the OUPIA. The Act continues by mediating other discrepancies or ambiguities regarding which principals guide the trustee: the Act controls where the governing instrument is silent, and all receipts or disbursements are credited/charged to principal if neither the Act nor the instrument provides an applicable rule.[16]

The OUPIA grants trustees one other significant power outside of Articles 2 through 5, again arguably (but unlikely) beyond the settlor's control. Under Article 1, a trustee may adjust between income and principal if (1) the trust keys distribution of the fund to income and (2) the trustee determines that without such adjustment it would be unable to administer the trust impartially, treating all beneficiaries with fairness and reason.[17] In other words, the trustee may only exercise the power to make adjustments if the trustee is otherwise unable to be fair and reasonable to all beneficiaries, accounting for the specific directives of the governing instrument.

Finally, the OUPIA recognizes that the governing instrument may grant the trustee discretionary powers.[18] Where so, a court may intervene only if the trustee's exercise of power abuses its discretion.[19] The Act confirms that the mere fact that a trustee makes a discretionary allocation contrary to one of its rules creates no presumption of either trustee imprudence or partiality.[20]

2. *Manifesting Settlor's Intent*

Recognizing the primacy of intent effectuation within trust administration and the ability of the settlor's contrary intent to supercede the provisions of the OUPIA, the question becomes one of sufficiency: what language a settlor must employ to override the application of the Act. The problem is particularly acute regarding the allocation of receipts and disbursements between income and principal. While the OUPIA offers no clear answer, the comments guide:

16. 60 OKLA. STAT. § 175.103(A)(2)-(4) (2001).
17. *Id.* §§ 175.104 (A), 175.103(B).
18. *Id.* § 175.103(A)(2).
19. See *infra* Part III.B.4 for discussion of the exercise of discretion and judicial review.
20. 60 OKLA. STAT. § 175.103(A)(2) (2001); UNIF. PRINCIPAL & INCOME ACT § 103(a)(2) cmt. (amended 1997), 7B U.L.A. 140 (2000).

> The terms of a trust may provide that the trustee, or an accountant engaged by the trustee, or a committee of persons who may be family members or business associates, shall have the power to determine what is income and what is principal. If the terms of a trust provide that this Act specifically or principal and income legislation in general does not apply to the trust but fail to provide a rule to deal with a matter provided for in this Act, the trustee has an implied grant of discretion to decide the question.[21]

Generally, settlors who intend to override the application of a uniform act must clearly express that intent in the trust instrument.[22] This test is rephrased, with its thrust intact, in a recent case interpreting the Act that questioned whether a direction to distribute "accumulated income" to remainder beneficiaries on the termination of the life estate was unambiguous:

> If the trust document has terms contrary to the provision of the Act, the trust document controls. The trust document also controls when the language of the trust document is clear and unambiguous. Only if the language of the trust document is ambiguous and the terms of the trust document are not contrary to the provisions of the Act will the Act apply.[23]

The court determined that the directive was indeed unambiguous and held that the trust document preempted the application of the Uniform Act.[24]

The deceptively easy task of stating the rule pales before the critical step of applying it. In the single Oklahoma case on point,[25] a decedent gave his wife a life estate in real property "*for and during her lifetime*, she to have and enjoy *all* of the income and *benefits of whatsoever kind, nature and source*."[26] When the decedent died, the real estate was under an oil and gas lease, requiring the Oklahoma Supreme Court to confront whether it should

21. UNIF. PRINCIPAL & INCOME ACT § 103 cmt. (amended 1997), 7B U.L.A. 141 (2000).

22. *See, e.g., In re* Estate of Reynolds, 432 A.2d 158, 165 (Pa. 1981) (holding that the direction that "any and all dividends shall be considered as income" did not override the application of the Uniform Act with respect to the allocation of a dividend paid in stock of the declaring company); *In re* Estate of Weiss, 309 A.2d 793, 799 (Pa. 1973) (holding that the power to allocate capital gains to income or principal in accordance with applicable law with the determination of the trustees to be binding was a clear direction in the trust instrument releasing the trustee from the rules of the Uniform Act).

23. Hedrick v. West One Bank, Idaho, N.A., 853 P.2d 548, 553 (Idaho 1993) (citations omitted) (interpreting the similar provision under the 1962 Act).

24. *Id.*

25. *In re* Estate of Hixon, 1985 OK 18, 715 P.2d 1087.

26. *Id.* ¶ 1, 715 P.2d at 1088 (emphasis added).

apportion lease proceeds between the life tenant and remainder beneficiaries in accordance with the 1931 Act or otherwise distribute them pursuant to the decedent's express language. Guided by the cardinal precept of intent effectuation,[27] the court concluded that the surviving spouse received not only the property's income, but also its "benefits," including the right to all royalty income during her life.[28]

Other jurisdictions addressing the issue have had little difficulty determining that a settlor intended to override the application of the Uniform Act.[29] For example, a trustee's discretionary power to "allocate all capital gains resulting from the sale or exchange of trust assets, to income or to principal, or partly to either, in accordance with applicable Law,"[30] led a court to conclude that the quoted language was a clear direction by the testator to override the application of the Uniform Act.[31] The court's determination survived the challenge that the "applicable Law" referred to meant the Uniform Act itself.

At a more essential level, is the authority to allocate receipts and disbursements between income and principal — a generic power found in most trust documents — sufficient to preempt the Act's application? If the language granting the trustee discretion is unambiguous, the answer is yes. Consider a trust document that granted the trustee power "[t]o allocate any property received or charge incurred to principal or income or partly to each as my corporate executor or trustee from time to time thinks proper, regardless of whether such allocation follows the usual rules of trust accounting."[32] Not surprisingly, the court concluded that the Uniform Act did not apply.[33] A Michigan court reached the same result when the trust instrument granted the trustee power to "allocate all receipts and disbursements between income and

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27. 84 OKLA. STAT. § 151 (2001).

28. *Hixon*, ¶ 7, 715 P.2d at 1090. The court stated:

> In accordance with Section 175.26, the testator has made provision touching all matters covered by the Uniform Principal and Income Act, and such provision and direction shall control notwithstanding the Act. The legitimate function of the Act takes hold only where such provision has not been made, and cannot otherwise control or vary expressed testamentary disposition, or prevent its execution.

Id. (citation omitted).

29. *In re Estate of Reynolds*, 432 A.2d 158 (Pa. 1981), is an exception to this rule. In that case, the Pennsylvania Supreme Court held that the direction that "any and all dividends shall be considered income" did not override the application of the Uniform Act with respect to the allocation of a dividend paid in stock of the declaring company. *Id.* at 165.

30. *In re* Estate of Weiss, 309 A.2d 793, 795 (Pa. 1973).

31. *Id.* at 799.

32. Provident Nat'l Bank v. United States, 353 F. Supp. 1025, 1027 (E.D. Pa. 1973).

33. *Id.* at 1029.

principal in such manner as the Fiduciaries shall deem just and equitable, regardless of any rule of law or statute to the contrary."[34]

Courts have reached the same result with more equivocal phrasing. For example, the Arizona Supreme Court summarily determined that granting the trustee the authority "to determine principal and income for all purposes" was sufficient to preclude Uniform Act application,[35] and the Michigan Supreme Court determined that a direction to "collect the income from the property comprising the trust estate, pay all taxes and incidental expenses of the trust, and . . . remit the net income derived therefrom"[36] to the income beneficiaries directed the trustee to pay all taxes from the income, thus preempting the Uniform Act.[37] Similarly, the Washington Supreme Court determined that authority granted to the trustee to "determine what is principal or income" again preempted Act application.[38] Perhaps the Idaho Supreme Court correctly summarized the interaction of the Uniform Act and trust terms. After acknowledging that a settlor may override the application of the Uniform Act, the court observed that "the Act is not assumed to apply" because the trust document will control.[39]

Even though courts are willing, and perhaps even anxious, to find a contrary intent expressed in trust instruments, practitioners should note that in no case has a court determined that the mere power to *allocate* receipts and disbursements between income and principal overrides the application of the Uniform Act. Such a statement in the governing document is hardly a clear and unambiguous declaration of the settlor's desire to override the OUPIA. More importantly, even where the settlor's intent to override the Act is clear, the trustee still must (1) comply with the terms of the trust instrument; (2)

34. Detroit Bank & Trust Co. v. United States, 338 F. Supp. 971, 975 (E.D. Mich. 1971).

35. *In re* Estate of Gardiner, 425 P.2d 427, 428 (Ariz. 1967) (focusing primarily on whether the trustee's allocation of the gain on the sale of real estate to income was an abuse of discretion under common law principles).

36. Donovan v. Nat'l Bank of Detroit, 185 N.W.2d 354, 355 (Mich. 1971).

37. *Id.* at 357. In *Donovan*, the issue was whether taxes on capital gains were chargeable against income or principal. After determining that the quoted language required the trustee to pay all taxes from income, the majority concluded that the tax on capital gains was an "extraction" and not a tax and thus should be charged against principal. *Id.* A persuasive dissent argued that the Uniform Act should apply because the language in the trust instrument did not contain a clear expression of contrary intent. *Id.* at 358 (Brennan, J., dissenting).

38. Templeton v. Peoples Nat'l Bank of Wash., 722 P.2d 63, 66 (Wash. 1986) (holding that the quoted language authorized the trustee to allocate annuity payments between income and principal, and the guidelines in the Uniform Act thus did not control).

39. *In re* Testamentary Trust Established Under the Will of Klingensmith, 853 P.2d 548, 553 (Idaho 1993).

exercise that level of discretion that the settlor contemplated; and (3) recall that its actions remain subject to judicial review.[40]

B. General Standards: The Duty of Impartiality

Whether the Act is speaking to the allocation of receipts and disbursements between principal and income upon the inception of, during, or at the termination of the relevant income interest, a foundational tenet remains: the common law obligation of impartial trust administration, based on what is fair and reasonable to all beneficiaries.[41]

The *Restatement of Trusts* requires trustees to deal impartially with beneficiaries, regardless of whether the beneficiaries are entitled to simultaneous or successive interests in the trust property.[42] For example, if a trust instrument provides for some temporal income interest to Beneficiary *A* followed by principal to Beneficiary *B*, the trustee owes duties to both to generate a reasonable income and yet preserve the property for subsequent distribution.[43] Note the inherent conflict, upon which the comment to the *Restatement* elaborates:

> Although the trustee is not under a duty to the beneficiary entitled to the income to endanger the safety of the principal in order to produce a large income, he is under a duty to him not to sacrifice income for the purpose of increasing the value of the principal. Thus, the trustee is under a duty to a life beneficiary not to purchase or retain unproductive property or property which yields an income substantially lower than that which is normally earned by trust investments, although it is probable that the property will appreciate in value.
>
> On the other hand, the trustee is under a duty to the beneficiary who is ultimately entitled to the principal not to purchase or retain property which is certain or likely to depreciate in value, although the property yields a large income, unless he makes adequate provision for amortizing the depreciation.[44]

Speaking on point, the OUPIA expressly acknowledges that a trustee's determination made in accordance with the trust's provisions is presumed fair and reasonable[45] and that a trustee may only adjust between principal and

40. *See infra* Parts III.B.3.b and B.4.
41. 60 OKLA. STAT. § 175.103(B) (2001).
42. RESTATEMENT (SECOND) OF TRUSTS §§ 183, 232 (1959).
43. *Id.* § 183 cmt. a.
44. *Id.* § 232 cmt. b (citation omitted).
45. 60 OKLA. STAT. § 175.103(B) (2001).

income if it determines that doing so would be fair and reasonable to all beneficiaries.[46] Analysis should therefore begin with the trustee's general obligation in allocating receipts and disbursements.

As discussed, the trustee's primary obligation is to administer the trust or estate in accordance with the terms of the governing instrument. Where the document speaks, its provisions control even if they conflict with the OUPIA;[47] where the document is silent, the OUPIA controls the trustee's administration.[48] If a trust authorizes the trustee to favor one beneficiary at the expense of another, a court will not control the exercise of the trustee's discretion in allocating receipts and disbursements unless that action constitutes abuse.[49]

Should both the governing instrument and the OUPIA fail to cover an allocation question, as with an unanticipated transaction, the OUPIA provides that the trustee should add the receipt to, and charge the disbursement against, the principal.[50] This obligation does not, however, override the fiduciary obligation to be fair and reasonable to all beneficiaries.

C. Defining Key Terms

The Act comprehensively answers questions of income/principal allocation and receipt/disbursement apportionment at all stages of income interest management: commencement, duration, and termination. The rules attending each stage of the interest are detailed below. But because the Act keys so much to the asset itself and the specific point of time under inquiry, it is critical to identify the relevant terms before turning to the rules that apply.

An income interest is "the right of an income beneficiary to receive all or part of [a trust's] net income," regardless of whether the trust instrument

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46. *Id.* § 175.104(A).

47. *Id.* § 175.103(A)(1).

48. *Id.* § 175.103(A)(3).

49. *See* RESTATEMENT (SECOND) OF TRUSTS § 183 cmt. a (1959). The more difficult issue is whether the governing instrument overrides the application of the OUPIA. For a detailed discussion, see *supra* Part II.A.

A closely related issue is the proper standard to apply when the trust instrument grants the trustee discretion with respect to the exercise of a power. The OUPIA does not prevent the trustee from exercising a discretionary power, even though the result is different from that which the OUPIA would otherwise dictate. 60 OKLA. STAT. § 175.103(A)(2) (2001). The common law, however, still imposes limits with respect to the exercise of this discretion. Generally, a court will not intervene unless the trustee in exercising or failing to exercise its discretion acts dishonestly, acts with an improper motive, fails to use its judgment, or acts beyond the limits of reasonable judgment. *See* RESTATEMENT (SECOND) OF TRUSTS § 187 (1959). For a complete discussion of the exercise of discretionary powers, see *infra* Part III.B.4.

50. 60 OKLA. STAT. § 175.103(A)(4) (2001).

mandates or permits discretion in its distribution.[51] An income interest commences on the date specified in the trust instrument;[52] absent a specified date, the interest begins "on the date an asset becomes subject to a trust or a successive income interest."[53] An asset becomes subject to an *inter vivos* trust on the date the settlor transfers it to the trustee.[54] If an asset becomes part of a testamentary or pour-over trust, an income interest in the trust begins on the date of the decedent's death, even though the actual distribution from the estate to the trust does not immediately occur.[55]

If the trust instrument does not specify a date for the commencement of an income interest and if a third party transfers an asset to a fiduciary because of an individual's death, the income interest commences on the date of that person's death.[56] If the transferor is another trust, that trust must also transfer income generated from the decedent's death.[57] Any income that the transferee trustee receives is allocated to income and is distributable to the income beneficiary.[58]

Within the context of an asset transfer by a third party trust, this rule makes sense. The transferor trust must account for, and will normally be quite able to convey, the additional funds attributable to the asset's temporary retention. The provision loses some logic if the transferor is an individual. Absent a contractual obligation, it is unlikely that a court would require an individual to disgorge any income received between the time of the decedent's death and the subsequent asset transfer to the trustee. In this setting, a court could

51. *Id.* § 175.102(6).

52. *Id.* § 175.301(A).

53. *Id.*

54. *Id.* § 175.301(B)(1).

55. *Id.* § 175.301(B)(2). Although the beneficiary is entitled to the income from the property commencing at the testator's death, a trustee can determine the amount distributable to the beneficiary by applying the rules in sections 175.201(1) and 175.302. For example, Settlor *S* creates a trust directing that Trustee *T* make a discretionary payment of income generated by the trust to Beneficiary *B* for education and support during *B*'s life, then to *C*, who is to receive all trust income for life, then to *D* free and clear of the trust. *B* and *C* each have income interests. If *S* transferred the trust fund assets to *T* on December 1, 2003, but stated that *B*'s right was to begin on January 1, 2004, then that is the date *B*'s income interest will commence, triggering the allocation rules set forth in the Act. Without such explicit directive, *B*'s interest would begin on December 1. If the trust were created in *S*'s will, then *B*'s income interest would begin on the day that *S* died irrespective of an administrative time lapse during the pendency of probate.

56. 60 OKLA. STAT. § 175.301(B)(3) (2001).

57. *See id.* §§ 175.201-175.202; *see also infra* Part III.B.1.a (discussing transfers from entities).

58. 60 OKLA. STAT. § 175.402 (2001).

determine that there is an insufficient causal relationship between the decedent's death and the third party's transfer of an asset to the trustee.[59]

An income interest terminates on the day before an income beneficiary dies, if it is an income interest for life,[60] and otherwise, on the day before the terminating event occurs.[61] If a trust instrument provides for successive income interests, the succeeding income beneficiary is entitled to the trust's net income commencing on the day after the preceding income interest terminates.[62] If a trust obtains an income beneficiary after a period during which there was no beneficiary to whom a trustee could distribute income, the OUPIA treats the preceding period as the end of an income interest.[63] Thus, the rules relating to the apportionment of receipts and disbursements between successive income interests apply.[64]

III. Managing Assets Under the Act

A. Apportionment at the Beginning of the Income Interest

An income interest is about to begin. Where do things stand at its inception, i.e., how much of the trust fund is apportioned to income versus principal at that precise point in time? Irrespective of whether the trust is revocable, irrevocable, *inter vivos*, testamentary, or poured into one or the other,[65] Article 3 controls. If the income receipts and disbursements are treated as received or paid by the entity *before* the income interest commences, the OUIPA allocates them to the preceding income interest, if

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59. Title 60, section 175.301(B)(3) of the Oklahoma Statutes only applies if a third person makes the transfer "because of" the decedent's death. The Act gives no guidance with respect to the required relationship between the two events. For example, if a child approves of a charitable trust established under his mother's will, a court would not view a subsequent transfer from the child to the trust as being made because of the mother's death.

60. 60 OKLA. STAT. § 175.301(D) (2001).

61. *Id.* For example, a beneficiary may be entitled to an income interest for a term of years or while she remains single.

62. *Id.* § 175.301(C).

63. *Id.* § 175.301(D).

64. The comments provide an example:

> [Suppose] a settlor creates a trust for grandchildren before any grandchildren are born. When the first grandchild is born, the period preceding the date of birth is treated as having ended, followed by a successive income interest, and the apportionment rules in Sections 302 and 303 apply accordingly if the terms of the trust do not contain different provisions.

UNIF. PRINCIPAL & INCOME ACT § 301 cmt. (amended 1997), 7B U.L.A. 155 (2000).

Under our earlier trust example, *B*'s income interest would end on the day before she died, and *C*'s income interest would begin on the day of *B*'s death.

65. *Id.* § 302 cmt., 7B U.L.A. at 157.

there is one, and if not, to principal. If the income receipts and disbursements are treated as received or paid by the entity *after* the income interest commences, the OUIPA allocates them to the current income beneficiary.[66]

By its terms, section 175.302 mainly applies to receipts and disbursement that are allocated to income. To make this determination, the trustee first must determine what is "income" under the rules in Articles 4 and 5.[67] In addition, section 175.201(1), which relates to the allocation of income receipts and disbursements to a beneficiary who receives a specific gift of property, supercedes the rules set forth in section 175.302.[68] Thus, if the decedent makes a testamentary gift of specific property to a beneficiary, the executor must also distribute the net income and principal receipts to that beneficiary.[69]

The apportionment of receipts and disbursements at the beginning of an income interest depends on their due date, with a trust receipt due on the date that the payer must make the payment, and a disbursement due on the date that the trust is required to make the payment.[70] If a trustee receives an amount or pays a disbursement at regular intervals, the due date is periodic, meaning the law treats each payment date as a separate due date.[71] This rule applies to receipts such as lease payments, dividends, interest payments, and annuities and to distributions such as mortgage payments.[72] The due date for dividends and other distributions from entities within the meaning of section 175.401[73] is the "record date," or the date fixed by the entity to identify the person entitled to the distribution.[74] If there is no record date, the due date is the date the entity declared that it would make the distribution.[75] If the entity specifies no payment date and if the rules with regard to distributions from entities do not apply, there is no due date for purposes of apportioning the receipt or disbursement.

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66. For rules regarding when an income interest commences, see 60 OKLA. STAT. § 175.301 (2001).

67. *See infra* Part III.B (discussing allocation during the administration of the income interest).

68. *See* 60 OKLA. STAT. § 175.201(1) (2001).

69. The statute is admittedly ambiguous. Section 175.302(A) clearly defers to the allocation provided for in section 175.201(1). Section 175.201(1) states, however, that a trustee must classify receipts from property that is the subject of a specific gift in accordance with Articles 3 through 5, which includes section 175.302.

70. *See* 60 OKLA. STAT. § 175.302(C) (2001).

71. *Id.*

72. UNIF. PRINCIPAL & INCOME ACT § 302 cmt. (amended 1997), 7B U.L.A. 157 (2000).

73. *See infra* Part III.B.1.a.

74. 60 OKLA. STAT. § 175.302(C) (2001).

75. *Id.*

The OUIPA does not apportion periodic income receipts and disbursements between income and principal. In other words, if a dividend record date occurs before the asset becomes subject to the trust or before the decedent's death,[76] the dividend is allocated to principal.[77] If the record date occurs after the asset becomes subject to the trust or after the decedent's death, the dividend is allocated entirely to income.

The rules differ for nonperiodic income receipts and disbursements, which are apportioned between income and principal based on daily accrual regardless of whether the payment has a due date.[78] The OUIPA allocates to principal that portion of the receipt or disbursement treated as accruing before the decedent's death or the commencement of an income interest, and allocates the remainder to income. For example, interest on an obligation that does not provide for a payment date, such as an income tax refund, is apportioned to principal to the extent it accrues before a person dies or the asset becomes subject to a trust, and to income to the extent it accrues after that date.[79] The same rule applies to interest on an obligation that has a due date but does not provide for periodic payments, such as a promissory note requiring both interest and principal to be paid on a single specified date.[80]

One last rule regarding apportionment at an income interest's commencement relates to zero-coupon bonds. Assume that the decedent owned a zero-coupon bond that passes to a testamentary trust. If the trust receives the proceeds more than one year after the decedent's death, it must allocate all of the proceeds to principal.[81] If, however, it receives the proceeds

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76. *See id.* § 175.301(B).

77. Coupled with basic principles of property law, an analysis of section 175.302, particularly subpart (c), leads to the following analysis in dividend issuance: Because a dividend's due date is the record date rather than the payment date, the dividend is allocated to principal regardless of whether the trust receives the dividend before or after the asset becomes subject to the trust. In the case of an *inter vivos* trust, if the settlor receives the dividend before the asset becomes subject to the trust, the dividend property remains that of the settlor. If the record date is before the stock's contribution to the trust, the settlor will receive the payment. If the settlor permits the dividend to be paid to the trust, it should be viewed as an additional principal contribution.

78. 60 OKLA. STAT. § 175.302(B) (2001).

79. UNIF. PRINCIPAL & INCOME ACT § 302 cmt. (amended 1997), 7B U.L.A. 157 (2000).

80. If the decedent specifically gives an obligation that does not provide for periodic receipts to a beneficiary, the trust must treat the income accrued as of the decedent's death as a principal receipt. *See* 60 OKLA. STAT. § 175.302(B) (2001). It still passes, however, to the beneficiary because she is entitled to the obligation's net income and principal receipts. *See id.* § 175.201(1).

81. *Id.* § 175.406(B). The one-year period begins to run at the decedent's death. Because it is a testamentary transfer to trust, the income beneficiary is entitled to the net income from the decedent's death the day the asset becomes subject to the trust. *See id.* § 175.301(A), (B)(2).

within that post-death year, the trustee may treat as income the excess of the proceeds over the purchase price or value when acquired.[82] Because the trust acquires the bond as of the decedent's death, the amount allocated to income equals the post-death increase in the value of the bond. The same rule applies to *inter vivos* trusts.

B. Allocation of Receipts and Disbursements During Administration

From perspectives of both duration and complexity, most of the work that the trustee faces in allocating receipts and disbursements comes into play not at the commencement of the income interest, but throughout its subsequent administration. Given the trustee's duty to manage the trust fund, the res is never static. Property flows into and out of the trust account continuously, as, for example, trust property is sold or investment decisions are made. The rules are fairly straightforward under general trust doctrine. Regarding receipts, income derived from the use of the res, such as rents, interest, and ordinary cash dividends, is income, whereas property received as substitute for the res, including proceeds from its sale, is principal.[83] Expenditures, which mainly include basic costs of trust administration, are paid from the trust income if they are "ordinary, current and regularly recurring"[84] and from the trust principal if otherwise.[85] The OUPIA replaces the generalized *ad hoc* approach suggested by the preceding rules with fairly detailed allocation directives for both receipts and disbursements.

1. Allocation of Receipts During Administration

Article 4 allocates receipts between income and principal and is divided into three sections: (1) Receipts From Entities (60 OKLA. STAT. §§ 175.401-175.403); (2) Receipts Not Normally Apportioned (60 OKLA. STAT. §§ 175.404-175.407); and (3) Receipts Normally Apportioned (60 OKLA. STAT. §§ 175.408-175.418).[86]

a) Receipts From Entities

Section 175.401 governs the allocation of receipts from entities. As used,

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82. *Id.* § 175.406(B).

83. GEORGE T. BOGERT, TRUSTS 403 (6th ed. 1987).

84. *Id.* at 446.

85. *Id.*

86. As detailed in Part II.A., *supra*, the rules outlined in Article 4 only apply if the settlor fails to override their application in the governing instrument. Recall as well that if the terms of the trust instrument and the OUPIA do not provide for a rule with respect to the allocation of a receipt, the trustee must allocate the receipt to principal. 60 OKLA. STAT. § 175.103(A)(4) (2001).

the term "entity" generally excludes (1) estates and other trusts, and (2) businesses that the trustee conducts and elects to account for separately.[87] It is therefore appropriate to discuss receipts from these exceptions before addressing the general provision.

(1) Receipts from Estates and Other Trusts[88]

If the terms of the recipient trust specifically address the allocation of receipts from estates and other trusts and if the governing instrument of the distributing estate or trust is silent, the trustee makes allocations pursuant to the terms of the recipient trust.[89] If the terms of the recipient trust are silent, however, the trustee must allocate to income any amount received as an income distribution from the estate or trust and must allocate to principal any amount received as a principal distribution.[90] In making this determination, the trustee of the recipient trust classifies the distribution based on the governing instrument of the distributing estate or trust, regardless of whether the distributing entity makes an unconventional allocation.[91] For example, if the terms of the distributing trust provide that the trustee should add a distribution made from income to the principal of the recipient trust, that provision controls and overrides the application of the OUPIA.[92]

Trouble arises when the terms of the recipient trust and distributing entity conflict, as where the distributing trust requires the recipient trust to treat all distributions as income, and the recipient trust requires the trustee to treat all receipts as principal. Such cases may compel the trustee to seek judicial resolution of the conflict.[93]

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87. *Id.* § 175.401(A).

88. The rules set forth in this section do not apply to receipts from trusts that are investment entities, *id.* § 175.402, such as mutual funds, common trust funds, business trusts, and other entities "organized as a trust for the purpose of receiving capital contributed by investors, investing that capital, and managing investment assets." UNIF. PRINCIPAL & INCOME ACT § 402 cmt. (amended 1997), 7B U.L.A. 163 (2000). Sections 175.401 and 175.415 control the classification of receipts from these entities. *See infra* Part III.B.1.a.(3).

89. UNIF. PRINCIPAL & INCOME ACT § 402 cmt. (amended 1997), 7B U.L.A. 162-63 (2000).

90. 60 OKLA. STAT. § 175.402 (2001).

91. UNIF. PRINCIPAL & INCOME ACT § 402 cmt. (amended 1997), 7B U.L.A. 162-63 (2000); *see also* 60 OKLA. STAT. § 175.103(3) (2001).

92. UNIF. PRINCIPAL & INCOME ACT § 402 cmt. (amended 1997), 7B U.L.A. 163 (2000).

93. *Id.* Although a court may believe that it should be principally concerned with the intent of the settlor as expressed in the governing instrument of the recipient trust, it is difficult to grant such intent priority over the intent of the settlor who established the distributing trust and who, through her largesse, named the recipient trust (or the trust's predecessor in interest) as beneficiary.

(2) Receipts from Businesses Treated as Separate Entities

The OUPIA grants a trustee unprecedented flexibility concerning the treatment of receipts from businesses and similar activities that the trustee conducts.[94] If a trustee determines that it is in the beneficiaries' best interests, the trustee may account separately for the business rather than as part of the trust's general records, regardless of whether the business assets are physically segregated from the trust's other assets.[95] Although, as usual, the trustee must guide its determination by the interests of all beneficiaries, a trustee enjoys broad discretion in deciding whether to unify or separate the accounting. Whereas it seems unlikely that income or remainder beneficiaries could require the trustee to account separately for an activity, it is perhaps more likely that a court would contravene a trustee's election to account separately.[96]

If the trustee elects to account separately for a business activity, the trustee treats the business activity as though it were owned by a separate entity. In fact, the trustee's power to allocate receipts among income and principal is comparable to the power of a corporation's board of directors to declare a dividend to its shareholders.[97] Otherwise stated, the trustee determines the extent to which it should retain its cash receipts for working capital, the acquisition or replacement of fixed assets, and other reasonably foreseeable business needs.[98] After setting aside appropriate reserves, the trustee may allocate any remaining receipts to income or principal.[99] If the trustee sells all

94. Activities for which the Act authorizes a trustee to maintain separate accounting records include: retail, manufacturing, service, and other traditional business activities; farming; raising and selling livestock and other animals; management of rental properties; extraction of minerals and other natural resources; timber operations; and activities to which section 175.414 applies. 60 OKLA. STAT. § 175.403(C) (2001). The trustee may not treat a traditional securities portfolio as a separate business to avoid the application of otherwise applicable provisions of the OUPIA. UNIF. PRINCIPAL & INCOME ACT § 403 cmt. (amended 1997), 7B U.L.A. 164 (2000).

95. 60 OKLA. STAT. § 175.403(A) (2001).

96. A trustee may account separately for an activity if "it is in the best interest of all the beneficiaries." *See id.* A court could base its decision to reverse a trustee's decision to account separately for a business activity on this standard. Conversely, even if it may be in the best interests of all beneficiaries, the statute does not appear to require the trustee to account for an activity separately.

97. UNIF. PRINCIPAL & INCOME ACT § 403 cmt. (amended 1997), 7B U.L.A. 164 (2000).

98. 60 OKLA. STAT. § 175.403(B) (2001).

99. *Id.* Again, the trustee must allocate between income and principal in the best interests of all beneficiaries. Although section 175.403(B) does not repeat this standard, the failure to act in the beneficiaries' best interests in making this allocation should prompt a court to conclude that it is not in the beneficiaries' best interests to account for the business activity separately as required by section 175.403(A). Surely, the drafters of the OUPIA would not have

or a portion of the business assets other than in the normal course of business, the trustee must treat the proceeds as principal to the extent it determines that they are "no longer required in the conduct of the business."[100] Thus, liquidation of a sole proprietorship or other activity for which the trustee has accounted separately results in all of the proceeds being allocated to principal — even those relating to the sale of assets such as accounts receivable and inventory, which historically would give rise to income.[101]

If the trustee elects not to account for a business activity separately, the receipt classification rules default to those generally expressed in Article 4.

(3) Receipts from Other Entities

Receipts from corporations, partnerships, limited liability companies, regulated investment companies, real estate investment trusts, common trust funds, and other organizations in which a trustee has an interest are allocated between income and principal in accordance with the rules set forth in section 175.401. These rules apply to distributions both from entities that the settlor contributed to the trust and from entities that the trustee acquired after the trust's creation.[102] As noted, special rules apply to receipts from estates and other trusts and from business activities for which the trustee elects to account for separately. Special rules also apply to receipts from asset-backed securities.

The reference to partnerships in section 175.401(A) includes all forms of partnerships, including limited partnerships, limited liability partnerships, and any variations that may have slightly different names and characteristics.[103] The relevant provision does not apply, however, to interests in property that the trustee owns as tenant in common with one or more co-owners, or to a joint venture if, under state law, the trustee's interest is regarded as that of a tenant in common.[104] In these cases, the trustee would classify the receipts in accordance with the rules for the underlying asset.[105]

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granted the trustee unfettered discretion to make this allocation.

100. *Id.* § 175.403(B).

101. UNIF. PRINCIPAL & INCOME ACT § 403 cmt. (amended 1997), 7B U.L.A. 164 (2000). If the sale occurs during probate or after an income interest terminates, all of the proceeds would be principal for purposes of section 175.201. *See id.*

102. *See* E. James Gamble, *If It's the 1990s, It Must Be Time For Another Principal and Income Act*, *in* 32ND ANN. UNIV. OF MIAMI PHILIP E. HECKERLING INST. ON ESTATE PLANNING 8-1, 8-29 (Tina Hestrom Portuondo ed., 1998). The author was the Co-Reporter for the 1997 Uniform Principal & Income Act.

103. UNIF. PRINCIPAL & INCOME ACT § 401 cmt. (amended 1997), 7B U.L.A. 161 (2000).

104. *Id.*

105. For example, a trustee would classify receipts from rental real estate in accordance with rules set forth in section 175.405.

While the trustee generally allocates receipts from an entity to income,[106] it must allocate the following receipts to principal: (1) property other than money; (2) money received in one distribution or a series of related distributions in exchange for part or all of a trust's interest in the entity; (3) money received in total or partial liquidation of the entity; and (4) money received from an entity that is a regulated investment company or a real estate investment trust if the money distributed is a capital gain dividend for federal income tax purposes.[107]

A capital gain dividend from a regulated investment company or real estate investment trust is the excess of the entity's net long-term capital gain over its net short-term capital loss.[108] A capital gain dividend does not include any short-term capital gain to the extent the short-term capital gain exceeds the entity's short-term capital loss. As a result, the OUPIA allocates to income cash received by the trust as the result of net short-term capital gains.[109]

The OUPIA changes the prior law relating to reinvested dividends. In most cases, a trustee will receive stock dividends in cash, which it will treat as income received.[110] The trustee may elect, however, automatically to reinvest dividends, receiving additional shares of stock of the declaring company. Under prior Oklahoma law, where a trustee had the option to receive a dividend either in cash or in the shares of the declaring company, the law treated the dividend as income regardless of the trustee's election.[111] By contrast, if a trustee elects to reinvest dividends (or continue an election made by the settlor), the 1997 Act treats the dividends as additions to principal.[112] Although the transaction could be viewed as the receipt of cash followed by the purchase of additional shares,[113] the OUPIA treats the election to reinvest similar to an adjustment under section 175.104 to transfer income to principal.[114] If the reinvestment of dividends fails to be fair and reasonable to all beneficiaries as required by section 175.103(B), however, the trustee must

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106. 60 OKLA. STAT. § 175.401(B) (2001).

107. *Id.*

108. I.R.C. §§ 852(b)(3)(C), 857(b)(3)(C) (2000); *see also* Treas. Reg. §§ 1.852-4(c)(1), 1.857-6(e)(1)(i) (as amended in 1986).

109. *See* Gamble, *supra* note 102, at 8-29.

110. *See* 60 OKLA. STAT. § 175.401(B) (2001).

111. 60 OKLA. STAT. § 175.29(A) (1991).

112. *See* 60 OKLA. STAT. § 175.401(C)(1) (2001).

113. The OUPIA would treat as income the receipt of a cash dividend, which would be distributable to the income beneficiary. *See id.* § 175.401(B). The subsequent purchase of additional shares would not reduce the amount of trust accounting income that the trustee must distribute.

114. *See* Gamble, *supra* note 102, at 8-30.

address the inequity by making an appropriate transfer from principal to income.[115]

The OUIPA allocates to principal money received from total or partial liquidation of an entity. Under section 175.401(D), a partial liquidation includes (1) any distribution designated by the entity as a partial liquidating distribution, regardless of the percentage of total assets that it represents; and (2) any distribution that exceeds 20% of the entity's gross assets, regardless of whether the entity identifies it as a partial liquidation.[116] In determining whether a distribution exceeds 20% of an entity's gross assets, the OUIPA ignores the amount equal to the income tax that the trustee or beneficiaries must pay on the distributing entity's taxable income.[117]

If a distribution is treated as a partial liquidation after applying the preceding test, the OUIPA treats as principal the portion of the distribution that exceeds the amount of income tax that the trustee or beneficiaries must pay on the distributing entity's taxable income.[118] Although the statute's wording is imprecise,[119] it appears to allocate to income any tax obligation that the trust incurs (or that the beneficiaries incur if the trust distributes the income to the beneficiaries in accordance with Internal Revenue Code sections 652 and 662) on income generated by the distributing entity and reported by the trust or its beneficiaries. This must be distinguished from the tax obligation that the trust or its beneficiaries might incur as a result of any taxable income that the trust reports directly as the result of the liquidating distribution.

Applying the provision may be complex. For example, assume that a trust's income is determined in accordance with the OUPIA and that it is required annually to distribute its income to a beneficiary. The trust is one of two equal partners in a partnership that owns three businesses. In the year in question, the partnership sells for $200,000 one of its businesses in which it has a basis of $150,000, recognizing $50,000 of long-term capital gain. The

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115. This transfer again would occur in accordance with the authority granted in sections 175.103 and 175.104 to make equitable adjustments.

116. 60 OKLA. STAT. § 175.401(D)(1)-(2) (2001); UNIF. PRINCIPAL & INCOME ACT § 401 cmt. (amended 1997), 7B U.L.A. 161 (2000). In making this determination, the trustee may rely upon a statement issued by the entity "if the statement is made at or near the time of the distribution by the entity's board of directors or other person or group" comparable to a corporation's board of directors. 60 OKLA. STAT. § 175.401(F) (2001).

117. 60 OKLA. STAT. § 175.401(E) (2001).

118. *Id.* § 175.401(B).

119. The trustee and beneficiaries technically do not pay tax on the distributing entity's taxable income. *See id.* § 175.401(E). Rather, the trust may be required to report a portion of the distribution as income, and it (or its beneficiaries if the income is distributed to them) must pay tax on taxable income which it is required to report.

partnership distributes $100,000 in cash to the trust, indicating that it is a partial liquidation within the meaning of section 175.401(D)(1). The trust must report $25,000 as long-term capital gain, 50% of the gain that the partnership recognized on the sale.[120] Further, assuming that the $100,000 distribution exceeds the trust's basis in its partnership interest, the trust will be required to report additional long-term capital gain as a result of the distribution.[121] In accordance with sections 175.401(C)-(E), $100,000 is allocated to principal, reduced by the amount of tax that the trust (or beneficiary) must pay on $25,000 of long-term capital gain, its share of the $50,000 gain recognized by the distributing partnership. The trust does not reduce the amount allocated to principal by the amount of tax payable by the trust (or beneficiary) on gain that it recognized directly as the result of the distribution exceeding its basis in the partnership interest.[122]

If both the trust and the beneficiary pay tax on long-term capital gain at the maximum rate of 20%, the tax attributable to the capital gain recognized by the partnership would be $5000 ($25,000 times 20%), and that portion of the $100,000 distribution is treated as income. If the entity reports the capital gain and pays the tax, $5000 is treated as a charge against income, eliminating the trust income for trust accounting purposes.[123] If, on the other hand, the trustee distributes the capital gain to the beneficiary, the beneficiary receives $5000 as an income distribution from the trust and pays the $5000 tax obligation personally, offsetting the distribution.[124]

The rules allocating receipts from entities set forth in section 175.401 do not override a trustee's power to adjust between income and principal.[125] For example, a large cash distribution from an entity that exceeds 10% but is less than 20% of its gross assets may have characteristics that suggest that a trustee should treat it as principal rather than income,[126] in which case it may be

120. I.R.C. §§ 1101, 1221 (2000).

121. *Id.*

122. However, the trust must charge the tax on this amount against principal. *See* 60 OKLA. STAT. § 175.505(B) (2001).

123. *See id.* § 175.505(A).

124. If the beneficiary's tax obligation is less than $5000, the amount attributed to income is correspondingly reduced under section 175.401(E), so that the distribution still equals the amount of the beneficiary's tax obligation. Although additional analysis is not warranted, there are situations where the calculation of the beneficiary's tax becomes interrelated with the amount of income that a trustee must distribute if the trustee distributes a portion of the income recognized by the selling partnership to the trust's beneficiary.

125. 60 OKLA. STAT. § 175.104(A) (2001).

126. The comments give three examples:

> [A]n entity may have received cash from a source other than the conduct of its normal business operations because it sold an investment asset; or because it sold a business asset other than one held for sale to customers in the normal course of

necessary for the trustee to make an appropriate adjustment.

b) Receipts Not Normally Apportioned

(1) Principal Receipts

Assets received from a transferor during her lifetime, from a decedent's estate, from a trust with a terminating income interest,[127] or from a payer under a contract naming the trust or its trustee as beneficiary generally are allocated to principal,[128] reflecting the transferor's presumed desire that the contributed asset remain part of the trust corpus rather than be distributed to the income beneficiary. This rule applies, however, only to the extent the OUPIA does not otherwise allocate the receipt to income, which it may do if the trust receives an income distribution from an estate or another trust.[129]

If a trustee sells, exchanges, or liquidates a principal asset, the trustee must also treat the money or other property that the trust receives in connection with the transaction as a principal asset.[130] This includes any realized profit. Correspondingly, a trustee must also charge any loss on the transaction against principal.

A trustee must make required trust expenditures relating to environmental matters from principal, including payments to third parties and costs of defending environmental claims.[131] Therefore, if a trustee recovers amounts from a third person to reimburse the trust for environmental expenditures, the trustee must allocate those receipts to principal except to the extent that they represent the trust's loss of income, in which case the trustee allocates them to income.[132]

The OUPIA normally requires a trustee to allocate proceeds that the trust receives in connection with an eminent domain action to principal.[133] If a separate award for loss of income is made for a period during which a current

> its business and did not replace it; or it borrowed a large sum of money and secured the repayment of the loan with a substantial asset; or a principal source of its cash was from assets such as mineral interests, 90% of which would have been allocated to principal if the trust had owned the assets directly.

UNIF. PRINCIPAL & INCOME ACT § 401 cmt. (amended 1997), 7B U.L.A. 161 (2000).

127. An income interest terminates when the right of an income beneficiary to receive all or a portion of the trust's net income ceases. *See* 60 OKLA. STAT. § 175.102(6) (2001); *supra* Part II.C.

128. 60 OKLA. STAT. § 175.404(1) (2001).

129. *See id.* § 175.402; *supra* Part III.B.1.a.(1).

130. 60 OKLA. STAT. § 175.404(2) (2001). A principal asset is an asset that is held in trust for distribution to a remainder beneficiary. *See id.* § 175.102(10).

131. *Id.* § 175.502(A)(7).

132. *Id.* § 175.404(3).

133. *Id.*

income beneficiary had a mandatory income interest,[134] however, a trustee must allocate that award to income.[135] Even though an eminent domain award includes an amount for the loss of income, the entire award is principal unless the amount attributable to the loss of income is separately stated.[136]

The OUPIA allocates to principal "[n]et income received in an accounting period during which there is no beneficiary to whom [the] trustee may or must distribute income."[137] If the trustee has discretion to make an income distribution, any income that it does not distribute to the income beneficiary normally is added to principal.[138]

In addition to the above rules, receipts may be allocated to principal as provided in Article 4, Part 3, which discusses receipts normally apportioned between income and principal.[139]

(2) Receipts from Rental Property

If a trustee determines that it is in the best interests of all the beneficiaries, it may elect to account separately for a rental activity as authorized by section 175.403(C)(4).[140] Otherwise, after considering the need to establish a reserve for depreciation,[141] a trustee allocates receipts from the rental of real and personal property, including any amount received for the cancellation or renewal of a lease, to income in accordance with section 175.405.[142]

A trustee must allocate an amount received as a security deposit or an amount to be applied against the rent for future periods to principal and hold

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134. A mandatory income interest is "the right of an income beneficiary to receive net income that the terms of the trust require the [trustee] to distribute." *Id.* § 175.102(7).

135. Thus, if a beneficiary has only a discretionary income interest, the trustee should allocate the entire award to principal. This does not preclude the trustee from making an equitable adjustment between principal and income as authorized by section 175.104(A).

136. UNIF. PRINCIPAL & INCOME ACT § 404 cmt. (amended 1997), 7B U.L.A. 165 (2000). The comments indicate that this is the same rule as the 1931 Uniform Act. *See* 60 OKLA. STAT. § 175.27(B) (1991).

137. 60 OKLA. STAT. § 175.404(5) (2001).

138. The terms of the governing instrument generally dictate this result. Although the OUPIA defines the amount of the trust's income available for distribution, it does not require that a trustee add any undistributed income to principal.

139. 60 OKLA. STAT. § 175.404(6) (2001); *see infra* Part III.B.1.c.

140. *See supra* Part III.B.1.a.(2). In this event, the trustee has broader discretion to allocate receipts to principal for working capital needs, to acquire or replace assets, and for other foreseeable needs of the business.

141. For purposes of determining the trust's net income, the OUPIA authorizes the trustee to transfer from income to principal a reasonable amount of the net cash receipts from a principal asset that is subject to depreciation. *See* 60 OKLA. STAT. § 175.503(B) (2001).

142. UNIF. PRINCIPAL & INCOME ACT § 405 cmt. (amended 1997), 7B U.L.A. 166 (2000).

it subject to the terms of the lease.[143] If the payment represents the prepayment of *rent* for the final period of the rental term, the trustee must allocate the paid amount to income for those periods, even though the tenant makes no additional payments. If the payment represents a security deposit that is refunded to the tenant, the OUPIA treats the disbursement as a charge against principal, and neither the payment's receipt nor disbursement affects the trust's net income.[144] If the trustee uses the security deposit to repair damage to the rental property, the OUPIA allocates the receipt to income during the period the repairs are made, and the trustee charges the cost of the repairs against income.[145] Thus, the transaction has a neutral effect on net income.

Special rules apply to improvements to rental property. If a landlord makes improvements at a tenant's request, the trustee may characterize a portion of future lease payments representing the reimbursement of principal expenditures as rent for purposes of invoking contractual or statutory remedies for nonpayment. The comments to the OUPIA indicate that the trustee may transfer an appropriate amount from income to principal to reflect the economic realities of the rental payments.[146] The OUPIA may require a similar adjustment if the tenant agrees to make significant improvements that will have residual value when they revert to the landlord at the end of the lease. During the lease term, the tenant may pay what appears to be below a market rent. Without an adjustment from principal to income, the trust's income beneficiary subsidizes an increase in the trust's principal that will ultimately inure to the benefit of the trust's remainder beneficiaries.[147]

The example in the OUPIA comments that recharacterizes a portion of a lease payment as the reimbursement of principal expenditures for improvements made by the trustee is actually the less compelling situation. Presumably, the trustee will use principal assets to improve the rental property.[148] If, as suggested by the comments, the trustee allocates to principal the increased rental payment attributable to the improvements, the income beneficiary foregoes the receipt of income on the amount invested in the leasehold improvements during the term of the lease. From an economic

143. 60 OKLA. STAT. § 175.405 (2001).

144. *Id.*

145. *Id.* § 175.501(3).

146. UNIF. PRINCIPAL & INCOME ACT § 405 cmt. (amended 1997), 7B U.L.A. 166 (2000). This may be accomplished pursuant to sections 175.504 or 175.104.

147. In this case, the trustee must make the adjustment pursuant to the authority granted in section 175.104.

148. The OUPIA would not classify the improvements as ordinary repairs, which are charged against income. *See* 60 OKLA. STAT. § 175.501(3) (2001).

standpoint, the trustee should allocate all lease payments to income, with a corresponding adjustment from income to principal for the expected depreciation of those improvements during the lease term.[149]

(3) Receipts from Obligations to Pay Money

The OUPIA allocates to income any amount the trust receives as interest, without any provision for amortization of premium in connection with amounts owed to the trust by third persons.[150] This is true regardless of whether the obligation's interest rate is fixed, variable, or floating.[151] Similarly, when a trust sells, redeems, or otherwise disposes of a debt obligation that the trust has held for more than one year, the OUPIA allocates to principal the entire amount received, even though the trust acquired the obligation at a discount.[152]

The OUPIA allocates to principal receipts from the sale, redemption, or disposition of a bond that does not pay income currently, such as U.S. savings bonds and zero-coupon bonds, if they are held more than one year.[153] Similarly, the OUPIA allocates to principal all receipts from the disposition of inflation-indexed bonds.[154] In deciding whether and to what extent to exercise the power to adjust as provided in section 175.104, however, the OUPIA directs the trustee to consider the effect of having a portion of the trust's assets invested in bonds that do not pay interest currently.[155]

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149. Depending on the lease negotiations, the reserve for depreciation may approximate the increased rental payment, in which case the net result is the same.

150. 60 OKLA. STAT. § 175.406 (2001).

151. UNIF. PRINCIPAL & INCOME ACT § 406 cmt. (amended 1997), 7B U.L.A. 167 (2000). The comments make clear that debt instruments which carry variable or floating rates are not derivative financial instruments as defined in section 175.414(A). *Id.*

152. 60 OKLA. STAT. § 175.406(A) (2001). This is the same result as under Oklahoma law prior to the enactment of the 1997 Uniform Act. *See* 60 OKLA. STAT. § 175.30 (1991).

153. UNIF. PRINCIPAL & INCOME ACT § 406 cmt. (amended 1997), 7B U.L.A. 167 (2000). If the trust holds such bonds less than one year, the trustee must allocate the increase in the value of the bonds to income. 60 OKLA. STAT. § 175.406(B) (2001).

154. UNIF. PRINCIPAL & INCOME ACT § 406 cmt. (amended 1997), 7B U.L.A. 167 (2000).

155. *Id.* The preceding rules do not apply to obligations to which the following sections apply: 175.409 (discussing receipts from deferred compensation, annuities, and similar payments), 175.410 (discussing receipts from assets, whose value will diminish or terminate because the asset is expected to produce receipts for only a limited period of time), 175.411 (discussing receipts from minerals, water, and other natural resources), 175.412 (discussing receipts from the sale of timber and related products), 175.414 (discussing receipts from derivatives and options), and 175.415 (discussing receipts from assets whose value is based on the right it gives the owner to receive distributions from the proceeds of financial assets that provide collateral for the security).

Assume that a trust pays $1100 for a $1000 bond because the bond's stated interest rate exceeds the current market rate. Under the OUPIA, all of the interest payments are allocated to income "without any provision for amortization of premium."[156] When the bond matures, the OUPIA allocates the proceeds to principal.[157] Over the life of the bond, the trust will distribute $100 of principal to the income beneficiary. Now assume that a trust purchases the same bond for $900 because the bond's stated interest rate falls below the current market rate. Again, the income beneficiary receives all of the interest, and when the bond matures, the OUPIA allocates the entire $1000 to principal. In this case, over the life of the bond, the trust will transfer $100 of interest income from income to principal. The drafters believed that over time, premiums and discounts tend to offset each other and that the benefit of precision in computing net income is offset by the additional accounting costs involved.[158]

When a bond matures, the trust may receive a single payment representing both the face value of the bond and the interest earned during the last accrual period. A trustee should allocate that portion of the payment representing interest to income rather than treat it as an amount received from the redemption of the bond.

In some instances, a trustee will acquire a debt obligation on the secondary market. As part of the purchase price, the purchaser normally pays the seller an amount representing the interest accrued from the last payment date to the date of the transaction. Under the OUPIA, the entire purchase price, including any interest accrued as of the date of the transaction, is a charge against principal.[159] Similarly, if a trustee sells a bond, the trustee will receive the interest that has accrued during that same period. In such a case, the OUPIA treats the proceeds, including any accrued interest, as a principal receipt, and no portion is allocated to income.[160]

(4) Receipts from Insurance Policies and Similar Contracts

Section 175.407 characterizes receipts from insurance policies and similar contracts. The OUPIA allocates life insurance proceeds payable to the trustee to principal,[161] as is true of a policy on a trust asset that insures against its loss,

156. 60 OKLA. STAT. § 175.406(A) (2001).

157. *Id.* § 175.406(B).

158. This does not preclude the trustee from adjusting under section 175.104 in appropriate circumstances.

159. 60 OKLA. STAT. § 175.103(A)(4) (2001).

160. Pursuant to section 175.406(B), the trustee must allocate to principal "an amount received from the sale . . . of an obligation to pay money to the trustee," without exception.

161. 60 OKLA. STAT. § 175.407(A) (2001).

damage, or destruction.[162] Thus, if a residence owned by the trust is destroyed by fire or if a third person is awarded title to it, the OUPIA treats the insurance proceeds as principal receipts. Contracts relating to deferred compensation, annuities, and other payments within the meaning of section 175.409(A), however, are subject to the rules set forth in that section, even though the trustee might characterize the receipts as insurance proceeds.[163]

If the insurance policy insures the trustee against loss of occupancy or other use by the income beneficiary, the OUPIA allocates the proceeds to income.[164] If a residence is destroyed by fire, the trustee should distribute the portion of the insurance proceeds that reimburses the income beneficiary for temporary living expenses to the income beneficiary.

If the trust operates a trade or business and carries business interruption insurance, the OUPIA generally allocates to income the proceeds that reflect the loss of income or profits.[165] If the trustee has elected to account separately for a business activity as provided in section 175.403, however, the trustee retains discretion to determine the extent to which the trust should retain the insurance proceeds as principal for future business needs.

Insurance companies may pay dividends to policy holders. A trustee should characterize these payments as a refund of a portion of the premiums paid during the year.[166] The allocation of dividends depends on whether the trustee charged the insurance premiums against income or principal. If the insurance protects against the "loss of a principal asset or the loss of income or use of the asset," the OUPIA charges the premium against income,[167] and the trustee must allocate any dividend on the policy to income. The OUPIA treats dividends on all other insurance policies, including life insurance, as the refund of a principal disbursement.[168]

c) Receipts Normally Apportioned

(1) Deferred Compensation, Annuities, and Similar Payments

The OUPIA details the allocation of deferred compensation, annuities, payments from retirement plans, and similar arrangements. Under section 175.409(A), a "payment" is one that a trustee receives over a fixed number of years or during the life of one or more individuals because of services

162. *Id.*
163. *Id.* § 175.407(C).
164. *Id.* § 175.407(B).
165. *Id.*
166. *Id.* § 175.407(A).
167. *Id.* § 175.501(4).
168. *Id.* § 175.502(A)(5).

rendered or property transferred to the payer in exchange for future payments. The comments to section 175.409(a) provide an excellent discussion of the provision's broad scope:

> Section 409 applies to receipts from all forms of annuities and deferred compensation arrangements, whether the payment will be received by the trust in a lump sum or in installments over a period of years. It applies to bonuses that may be received over two or three years and payments that may last for much longer periods, including payments from an individual retirement account (IRA), deferred compensation plan (whether qualified or not qualified for special federal income tax treatment), and insurance renewal commissions. It applies to a retirement plan to which the settlor has made contributions, just as it applies to an annuity policy that the settlor may have purchased individually, and it applies to variable annuities, deferred annuities, annuities issued by commercial insurance companies, and "private annuities" arising from the sale of property to another individual or entity in exchange for payments that are to be made for the life of one or more individuals. The section applies whether the payments begin when the payment right becomes subject to the trust or are deferred until a future date, and it applies whether payments are made in cash or in kind, such as employer stock (in-kind payments usually will be made in a single distribution that will be allocated to principal under the second sentence of subsection (c)).[169]

Many of the property interests outlined above could be described as liquidating assets — assets with a diminishing or terminating value given the expectation that they will only produce receipts for some limited term. The implication of section 175.409(E) is that section 175.410 has priority when determining the income/principal allocation of liquidating assets. The scope of section 175.410, however, does not include deferred compensation arrangements, annuities, and similar payments that fall within the scope of section 175.409.[170]

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169. UNIF. PRINCIPAL & INCOME ACT § 409 cmt. (amended 1997), 7B U.L.A. 170-71 (2000).

170. The comments confirm that, even though annuities and similar payments are liquidating assets of the kind described in section 175.410, section 175.409 controls the payments because of their special characteristics. UNIF. PRINCIPAL & INCOME ACT § 409 cmt. (amended 1997), 7B U.L.A. 170 (2000); *see also* 60 OKLA. STAT. § 175.410(A) (2001) (stating that the rules relating to liquidating assets do not apply to payments subject to section 175.409).

If the payer characterizes the payment as interest or a dividend, the trustee must allocate that portion of the payment to income.[171] The OUPIA allocates the remainder of the payment to principal.[172] For example, if a deferred compensation plan holds debt instruments and stock and provides for annual payment of the interest and dividends earned during the year to a trust, the OUPIA allocates those receipts to income.[173] If the person rendering the services receives a fixed dollar amount in the future and if the plan provides for the annual payment of interest during the intervening years, the OUPIA also allocates the interest payments to income.[174] The scope of this provision is fairly limited, however, and it does not apply to receipts from individual retirement accounts and similar arrangements.[175]

If a trustee does not characterize any portion of the payment as interest, a dividend, or an equivalent payment, section 175.409(C) controls the allocation of the receipt between income and principal. That section focuses on the trust's right to receive the payment rather than on the assets held in the fund from which the payments are made. If the federal income tax rules or the terms of the plan require the payer to make the payment, the OUPIA allocates 10% of the payment to income and the remainder to principal. If the payer is not required to make the payment or if the payment is the entire amount to which the trustee is entitled, the OUPIA allocates the entire payment to principal.[176] For purposes of this rule, if a trustee receives the payment pursuant to its exercise of a power of withdrawal, the OUPIA allocates the entire payment to principal.

There are two additional considerations. A trustee acting under the prudent investor rule may adjust between principal and income so long as it is fair and reasonable to all beneficiaries.[177] Further, if a trustee determines that an

171. 60 OKLA. STAT. § 175.409(B) (2001). This includes any payment "made in lieu of interest or a dividend." *Id.*

172. *Id.*

173. UNIF. PRINCIPAL & INCOME ACT § 409 cmt. (amended 1997), 7B U.L.A. 171 (2000). The same rule applies in the event that the account holds only "phantom" shares of stock and the plan provides that an amount be paid annually equal to the dividends that would have been declared if the shares were actually issued. *Id.*

174. *Id.*

175. *Id.* at 170. Section 175.409(C) covers receipts with respect to those plans. In addition, a spouse may claim a marital deduction with respect to a retirement account, in which case section 175.409(D) controls the allocation of the distributions.

176. In this case, OUPIA treats it as a mere change in the form of a principal asset. *See* 60 OKLA. STAT. § 175.404(2) (2001).

177. *See id.* §§ 175.103(B), 175.104. The comments describe an example in which a trust received minimum distributions from an IRA. The IRA's total return exceeded 10% of the minimum distribution that was allocated to income pursuant to section 175.409, and the value of the account's assets at the end of the year exceeded their value at the beginning of the year.

allocation between principal and income required by section 175.409 is insubstantial, it may allocate the entire receipt to principal unless one of the circumstances described in section 175.104(C) applies.[178]

A few examples illustrate the application of section 175.409. Trust *A* owned life insurance. When the insured died, the trust elected to receive $10,000 a year for twenty years rather than the lump sum benefit.[179] The OUPIA does not characterize any portion of the annual payment as income or a dividend within the meaning of section 175.409(B). As a result, the trustee must allocate 10% of each payment ($1000) to income and the balance to principal.[180] The result would be the same if the trust received payments for the life of an individual or if the transaction involved a private annuity where the trust transferred an asset to a third person in exchange for the right to receive a fixed sum for a period of years.[181]

Decedent *B* entered into a deferred-compensation agreement pursuant to which her employer agreed to pay *B* or her estate $5000 per year for ten years upon her death or retirement. Upon *B*'s death, the right to collect the remaining payments passed to a trust. The trustee must allocate 10% of each payment ($500) to income.[182] If the compensation agreement provided that the trust was entitled to the entire unpaid amount on *B*'s death in a single payment, the OUPIA allocates the entire receipt to principal because the payment represents the entire amount to which the trust is entitled within the meaning of section 175.409(C).

Decedent's employer, *C*, established a deferred-compensation plan funded exclusively with employer's stock. Under the terms of the plan, the employee was entitled to receive annually the dividends declared on the stock held by the plan. In addition, beginning five years after retirement or death, the decedent, or her assigns, had the annual right to withdraw 5% of the stock, and fifteen years after retirement or death, the plan distributed the balance to the

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The example lists factors that the trustee might consider when determining whether to make an adjustment as provided in section 175.104. *See* UNIF. PRINCIPAL & INCOME ACT § 104 cmt. (amended 1997), 7B U.L.A. 145 (2000).

178. *See* 60 OKLA. STAT. § 175.408 (2001).

179. If the trust elected to receive insurance proceeds in a single payment, the trustee must allocate the proceeds to principal. *See id.* § 175.407(A).

180. *Id.* § 175.409(C). Note that the amount allocated to income does not depend on the interest rate used to value the annuity for federal estate tax purposes or the interest rate used by the insurance company to determine the amount of the annual payment. *See* UNIF. PRINCIPAL & INCOME ACT § 409 cmt. (amended 1997), 7B U.L.A. 172 (2000).

181. If the trustee sells the property on an installment contract, the OUPIA allocates to income the portion of each installment that represents interest and the remainder to principal. *See* 60 OKLA. STAT. §§ 175.404(2), 175.406(A) (2001).

182. *Id.* § 175.409(C).

decedent, or her assigns. Upon the decedent's death, her rights were transferred to a trust. The trustee must allocate to income the annual payment representing the dividends declared on the stock held in the plan.[183] If the trustee exercises its discretion to withdraw 5% of the stock, the OUPIA allocates the entire amount withdrawn to principal because the deferred compensation plan need not make a payment within the meaning of section 175.409(C) to the extent the trustee exercises a right to withdraw.[184] When the plan terminates in the fifteenth year, the OUPIA allocates the entire amount (other than the dividend income earned in the year of distribution) to principal because the distribution represents "the entire amount to which the trustee is entitled."[185]

Trust *D* is the recipient of a unitrust payment equal to 5% of the value of the trust assets determined at the end of each year. Because this amount is determined without regard to the amount of income that the unitrust receives, section 175.409(C) controls the allocation of the receipt. Because it is an amount that the unitrust is required to pay, the trustee must allocate 10% of the receipt to income.

Trust *E* is the beneficiary of an IRA. If the trustee elects to withdraw the entire account on the participant's death, the OUPIA allocates the entire receipt to principal because it is a withdrawal of "the entire amount to which the trustee is entitled."[186] If the trustee elects to retain the IRA as a trust asset, the account is subject to federal tax rules that require payments to begin by a particular date and to be made over a specific number of years or a period measured by the lives of one or more persons. In this case, the trustee is entitled to receive a distribution based on the value of the account divided by the remaining number of years in the payment period, rather than the amount of income the IRA earned during the year. As a result, section 175.409(C) controls the allocation of distribution from the IRA (or a plan with similar payment provisions) rather than section 175.409(B). The trustee must allocate 10% of the distribution to income and the remainder to principal.[187]

183. *Id.* § 175.409(B).

184. *See id.* § 175.409(C). If the trust must make the payment within the meaning of section 175.409(C), the trustee must allocate 10% of the payment to income and the balance to principal.

185. *Id.*

186. *Id.* The OUPIA treats the resulting income tax obligation as a principal disbursement because it is based on receipts allocable to principal. *See id.* § 175.505(B).

187. UNIF. PRINCIPAL & INCOME ACT § 409 cmt. (amended 1997), 7B U.L.A. 172 (2000).

If an IRA is payable to a trust with respect to which the estate has elected to claim a marital deduction for qualified terminable interest property,[188] complex rules govern the amount of the required distributions.[189] The estate planner must comply with three distinct sets of rules: the minimum distribution rules, the QTIP requirements, and the terms of the governing instrument. Property qualifies for the QTIP marital deduction only if the surviving spouse is entitled to all of the income payable at least annually during her lifetime.[190] As a result, the income from the IRA must be distributed annually to the trustee and passed through to the surviving spouse.[191] The required minimum distribution, however, does not have to be distributed to the spouse. As a result, the greater of the IRA income and the minimum distribution must be distributed to the trustee each year, and only that portion that equals the IRA income must be distributed from the trust to the surviving spouse.[192] After the application of the general rules contained in sections 175.409(B) and (C), the trustee must allocate to income any additional amount necessary to ensure the availability of the marital deduction.[193]

(2) Receipts from Liquidating Assets

A liquidating asset's value diminishes or terminates because it produces receipts for a limited term given the passage of time (depreciation), natural effects of use, or both. According to section 175.410(A), liquidating assets include leaseholds, patents, copyrights, royalty rights, and rights to receive payments during a period of more than one year under an arrangement that does not provide for the payment of interest on unpaid balances.[194] Receipts from a liquidating asset such as a patent represent both the receipt of income as well as the change in the form of the underlying principal asset.[195] Accordingly, the trustee must allocate 10% of each receipt from a liquidating asset to income and the balance to principal.[196]

The definition of a liquidating asset is broad enough to include assets covered by other provisions. For example, oil and gas royalties are receipts from liquidating assets. The default rule established in section 175.410 does

188. *See* I.R.C. § 2056(b)(7) (2000). Under this type of trust, the spouse enjoys the income interest but the remainder beneficiaries are chosen by the decedent.

189. *See* JOHN R. PRICE, PRICE ON CONTEMPORARY ESTATE PLANNING § 13.14 (2d ed. 2000)

190. I.R.C. § 2056(b)(7)(B)(ii) (2000).

191. *See* Rev. Rul. 2000-2, 2000-1 C.B. 305.

192. *See* PRICE, *supra* note 189, § 13.14.1.

193. 60 OKLA. STAT. § 175.409(D) (2001).

194. *Id.* § 175.410(A). If the right to receive payments extends for a period of one year or less, the amount the trust receives is allocated to principal. *See id.* § 175.404(1).

195. *See id.* § 175.404(2).

196. *Id.* § 175.410(B).

not apply to receipts from deferred compensation, annuities, and similar plans within the scope of section 175.409, natural resources within the scope of section 175.411, timber within the scope of section 175.412, derivatives and options within the scope of section 175.414, asset-backed securities within the scope of section 175.415, or any asset for which the trustee establishes a reserve for depreciation pursuant to section 175.503. Further, if the trustee determines that an allocation between principal and income required by section 175.410 is insubstantial, the trustee may allocate the entire receipt to principal unless one of the circumstances described in section 175.104(C) applies to the allocation.[197]

Assume that a trust owns the right to receive lottery payments for a period of ten years. These arrangements typically do not provide for the payment of interest on unpaid balances and therefore are liquidating payments within the meaning of section 175.410.[198] As a result, the trustee must allocate 10% of each installment to income and the balance to principal.[199]

(3) Receipts from Minerals, Water, and Other Natural Resources

When adopting the 1997 Uniform Act, the Oklahoma legislature enacted the uniform provision relating to natural resources without change.[200] The following year, the legislature made significant changes to this provision.[201] Given the importance of mineral interests to Oklahoma trustees and beneficiaries, this provision deserves particular attention.

As is the rule in many other jurisdictions, mineral interests in Oklahoma are not real property per se, but they do create an *interest in* real property.[202] Other jurisdictions view mineral interests as incorporeal hereditaments, or nonpossessory interests.[203] If a mineral interest owned by an Oklahoma trust is located in a different state, the law of that situs may control the allocation of the receipts. Many factors influence the outcome: (1) choice of law provisions found in the trust's terms; (2) a court's willingness to follow the trust's terms; (3) the nature of the trust asset as the land itself versus a leasehold interest therein (common with oil and gas property); (4) the

197. *See id.* § 175.408; *see also supra* Part III.B.3.a.

198. Further, the person who purchases the lottery ticket does not transfer property to the state in exchange for future profits. If that were the case, section 175.409 would control the allocation of the payments between income and principal.

199. UNIF. PRINCIPAL & INCOME ACT § 410 cmt. (amended 1997), 7B U.L.A. 173 (2000).

200. Oklahoma Uniform Principal & Income Act, ch. 115, § 20, 1998 Okla. Sess. Laws 340.

201. Act of June 10, 1999, ch. 419, § 2, 1999 Okla. Sess. Laws 1981-82.

202. Amarex, Inc. v. El Paso Natural Gas Co., 1987 OK 48, ¶ 14, 772 P.2d 905, 908; Anson Corp. v. Corp. Comm'n of Okla., 1992 OK CIV APP 37, ¶ 9, 839 P.2d 676, 679.

203. For a detailed discussion, see RICHARD W. HEMINGWAY, LAW OF OIL AND GAS § 1.3 (3d ed. 1991).

characterization of the leasehold or its proceeds as real versus personal property; and (5) the characterization of personal property under applicable state law as a movable or an immovable interest for conflict of laws purposes.[204] These factors must be examined on a case-by-case basis. It is impossible to generalize the anticipated result.

It is also important to discuss the current status of the common law open-mine doctrine, which limits a life estate holder in use and enjoyment of the parcel's mineral deposits. The Oklahoma Supreme Court first embraced, and well explained, this doctrine in *Lawley v. Richardson*:[205]

> An examination of the foregoing cases, together with the authorities holding that a life tenant has no right to lease the lands for oil and gas purposes or to open new mines on the property where the opening of the same is not authorized under a contract executed prior to the death of the owner, discloses that a life tenant takes the land in the condition in which it was when the estate vested in him, and that he is entitled to all of the rents and profits which may accrue from the lands by reason of minerals which may be produced from mines or wells existing at the time of the death of the testator, or which may be produced from mines or wells opened under authority of conveyances executed prior to the vesting of the life estate. The life tenant has no authority by his own acts to obtain a profit on income from the land which would result from an injury to the inheritance, but he is entitled to the income and profits from the land when it is produced by reason of conditions which have been fixed by the deceased prior to his death, although the production of the same may result in an injury to the inheritance.[206]

Although the open-mine doctrine initially only applied to estates in land, many courts have applied the doctrine to beneficial interests in trusts. Thus, receipts under contracts executed by the settlor before trust formation have been allocated entirely to income, and receipts from contracts executed by the trustee after the trust's formation have been allocated to principal.[207] Before

204. UNIF. PRINCIPAL & INCOME ACT § 411 cmt. (amended 1997), 7B U.L.A. 175 (2000) (citing 5A AUSTIN W. SCOTT & WILLIAM F. FRATCHER, THE LAW OF TRUSTS § 648, at 531, 533-34; § 657, at 600 (4th ed. 1989)).

205. 1924 OK 144, 223 P. 156.

206. *Id.* ¶ 12, 223 P. at 159. See *Nutter v. Stockton*, 1981 OK 30, 626 P.2d 861, for a more recent affirmation of the open-mine doctrine.

207. GEORGE GLEASON BOGERT & GEORGE TAYLOR BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 827 (rev. 2d ed. 1981).

Oklahoma's enactment of the 1931 Uniform Principal and Income Act, the Oklahoma Supreme Court held that with respect to leases entered into after a trust's formation, lease bonuses and delay rentals were treated as income, and royalty payments were allocated exclusively to principal.[208] In 1941, Oklahoma enacted the 1931 Uniform Act, which abolished the open-mine doctrine as it applied to trusts.[209] The 1997 Uniform Act reaffirmed this position.[210]

Whether a trustee must allocate a mineral-related receipt to principal or income depends on its nature under the delivery terms. The following definitions guide in making this determination.[211]

(1) Bonus payment — payments made to the lessor for signing a lease.

(2) Delay rental — payments made to the lessor to maintain a lease during its primary term if drilling or production has not been initiated during the period specified in the lease.

(3) Annual rental — payments made during the lease term that are not dependent on actual production.

(4) Production payment — payments expressed as a fraction of production from a well that is free of production costs and are limited in quantity, money or time.

(5) Royalty payment — fractional shares of the gross production revenue from a well, not chargeable with expenses of development, operations, or production.

(6) Shut-in well payment — payments made when a well (normally a natural gas well) has been completed and is capable of producing in paying quantities, but which has been shut-in due to a lack of a pipe line connection, lack of a market, or a blowout.

(7) Take-or-pay payment — payments where the buyer agrees to either purchase and accept delivery of a given quantity of natural gas, or, if delivery is not accepted at that time, to pay for such a quantity.

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208. Franklin v. Margay Oil Corp., 1944 OK 316, ¶ 81, 153 P.2d 486, 501.

209. Oklahoma Trust Act, ch. 4, § 33, 1941 Okla. Sess. Laws 260-61; *see* 60 OKLA. STAT. § 175.33 (1991).

210. *See* 60 OKLA. STAT. § 175.411(C) (2001); UNIF. PRINCIPAL & INCOME ACT § 411 cmt. (amended 1997), 7B U.L.A. 175 (2000). The open-mine doctrine still applies in connection with the surviving spouse and minor children's homestead rights. *See* Hembree v. Magnolia Petroleum Co., 1935 OK 893, ¶ 15, 56 P.2d 851, 853; Aldridge v. Houston Oil Co., 1926 OK 80, 244 P. 782.

211. All definitions stem from NORMAN J. HYNE, DICTIONARY OF PETROLEUM EXPLORATION, DRILLING & PRODUCTION 47 (1991).

(8) Working interest — receipts that are generally chargeable with expenses of development, operation, and production, subjecting the owner to the risks of exploration and production.

Based on the foregoing definitions, the trustee should allocate the following receipts to income: (1) bonuses, delay rentals, and annual rents of less than $1000;[212] (2) 85% of bonuses, delay rentals, and annual rents that exceed $1000;[213] (3) that portion of production payments representing interest or its equivalent if and to the extent that the agreement creating the payment provides a factor for interest;[214] (4) 85% of amounts received as royalties, shut-in well payments, or take-or-pay payments;[215] and (5) 85% of amounts received from working interests and interests not otherwise referenced in sections 175.411(A)(1)-(3).[216]

Major differences exist between the revision that Oklahoma enacted in 1999 and the 1997 Uniform Act. Under the Uniform Act, a trustee must allocate nominal delay rentals and annual rents to income.[217] The Oklahoma legislature defined "nominal" to include payments of less than $1000 that aid a trustee in the administration of the trust. In addition, the Oklahoma legislature allocated to income nominal bonus payments, whereas the Uniform Act apportions all bonus payments between income and principal.[218] The allocation of nominal payments to income are made on a lease-by-lease basis. In other words, the OUPIA does not aggregate the receipts from more than one lease to determine whether the combined amount exceeds the $1000 threshold.[219]

The OUIPA departs from the Uniform Act in a far more significant way. The Uniform Act allocates 90% of most receipts to principal and the balance to income.[220] Oklahoma's 1999 legislation nearly reverses these percentages, allocating 85% to income and 15% to principal.[221] In a circuitous twist, the drafters of the 1997 Uniform Act substantially departed from the 1962

212. 60 OKLA. STAT. § 175.411(A)(1) (2001).

213. *Id.*

214. *Id.* § 175.411(A)(2).

215. *Id.* § 175.411(A)(3).

216. *Id.* § 175.411(A)(4). Receipts not enumerated above are allocated to principal.

217. UNIF. PRINCIPAL & INCOME ACT § 411(a)(1) (amended 1997), 7B U.L.A. 174 (2000).

218. *Id.*

219. Section 175.411(A)(1) expressly provides for this result. Any other interpretation would defeat the provision's purpose to simplify trust administration.

220. UNIF. PRINCIPAL & INCOME ACT § 411(a)(3)-(4) (amended 1997), 7B U.L.A. 174 (2000).

221. 60 OKLA. STAT. § 411(a) (2001).

Uniform Act, which was more in line with the current Oklahoma statute.[222] The drafters attempted to justify this change in the comments:

> A depletion provision that is tied to past or present [Internal Revenue] Code provisions is undesirable because it causes a large portion of the oil and gas receipts to be paid out as income. As wells are depleted, the amount received by the income beneficiary falls drastically. Allocating a larger portion of the receipts to principal enables the trustee to acquire other income producing assets that will continue to produce income when the mineral reserves are exhausted.[223]

Under the 1931 Uniform Act, which Oklahoma enacted in 1941, the portion allocated to principal was equal to the depletion deduction for federal income tax purposes.[224] Although depletion rates have changed over time and vary depending on the nature of the mineral interest, they generally range between 15% and 22%.[225] As result, prior law allocated between 78% and 85% of the receipts to income. Divorcing the apportionment between income and principal from the depletion rate makes sense because the factors that motivate Congress to establish depletion rates for federal income tax purposes are unrelated to the determination of the respective interests of the income and remainder beneficiaries. After the Oklahoma legislature enacted the 1997 Uniform Act, which significantly reduced the amounts allocable to income, however, banks, trust departments, and professional trustees lobbied the legislature to return the allocations to basically the same levels that existed prior to the 1997 Uniform Act.[226]

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222. The 1931 Uniform Act allocated exclusively to principal amounts received from the permanent severance of minerals. UNIF. PRINCIPAL & INCOME ACT § 9 (1931). The 1962 Act allocated 27.5% of the receipts from most mineral interests to principal and the balance to income. UNIF. PRINCIPAL & INCOME ACT § 9 (1962).

223. UNIF. PRINCIPAL & INCOME ACT § 411 cmt. (amended 1997), 7B U.L.A. 174 (2000).

224. Oklahoma Trust Act, ch. 4, § 33, 1941 Okla. Sess. Laws 260-61; *see* 60 OKLA. STAT. § 175.33 (1991).

225. *See* I.R.C. §§ 613, 613A (2000).

226. One could argue that the professional trustees were acting in the best interests of their beneficiaries in essentially reversing the allocation. The effect of the 1997 Uniform Act on current beneficiaries, however, was severely limited by the transitional rule under which a trustee can elect to follow prior law. *See infra* notes 230-38, 262-69 and accompanying text. The trustees legitimately may have been concerned about the effect the change would have on the presumed intent of settlors who create trusts after the OUPIA's effective date. More likely, they were concerned that the 1997 Uniform Act significantly reduced the amount of trust income, which directly affected trustee fees tied to that amount. It is also curious that the amendment to section 175.411 became effective upon its passage and approval because the legislature determined that an emergency existed and immediate action was necessary for

A specific rule applies to receipts from the sale of water. If the sale occurs from a renewable source, the OUPIA allocates all proceeds to income.[227] If the source is not renewable, the trustee must allocate 90% of the receipts to principal and the remainder to income.[228] Clearly, rivers and reservoirs fed by rivers are renewable sources. The Ogallala aquifer in western Oklahoma is probably not a renewable source within the meaning of section 175.411(B).[229] There undoubtably exist, however, renewable-source ground water aquifers in Oklahoma. If litigated, a court must make this determination on a case-by-case basis.

The OUPIA generally applies to all trusts and estates existing on November 1, 1998, except as otherwise expressly provided in the governing instrument.[230] A specific transitional rule applies, however, to receipts from natural resources. If the trust existed on November 1, 1998, the trustee may elect to allocate receipts from natural resources in accordance with section 175.411 or in the manner used by the trustee before the provision's effective date.[231] If the trust is established after the OUPIA's effective date, the trustee must allocate receipts from natural resources in accordance with the OUPIA.[232]

Notably, the OUPIA transitional rule also differs from the 1997 Uniform Act. The Uniform Act has a similar provision, but the determinative date is not the date of the trust's creation but rather the date of the trust's acquisition of the mineral interest.[233] A trustee of a trust established before the effective date of the enactment of the Uniform Act is bound by the Act if the trustee acquires a mineral interest after that date. Thus, under the Uniform Act, a trustee may allocate receipts from mineral interests acquired before the effective date of the Act differently than receipts from interests acquired after that date. Because the critical date in Oklahoma is the date of the trust's

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"preservation of the public peace, health and safety." Act of June 10, 1999, ch. 419, § 5, 1999 Okla. Sess. Laws 1983.

227. 60 OKLA. STAT. § 175.411(B) (2001).

228. *Id.*

229. For federal income tax purposes, water extracted by taxpayers from the Ogallala formation in the southern high plains is a "natural deposit" within the meaning of § 611(a) of the Internal Revenue Code for purposes of allowing a depletion deduction. *See* United States v. Shurbet, 347 F.2d 103, 107 (5th Cir. 1965) (holding that the Ogallala formation was not recharged annually to any significant degree and, being a depletable resource, thus qualified for a depletion allowance).

230. *See* 60 OKLA. STAT. § 175.602 (2001).

231. *Id.* § 175.411(D).

232. The terms of the trust instrument itself, however, may override the application of the OUPIA. *See* discussion *supra* Part II.A.

233. UNIF. PRINCIPAL & INCOME ACT § 411(d) (amended 1997), 7B U.L.A. 174 (2000).

creation, the same allocation rules should apply to all mineral interests the trust owns.[234]

In reality, the trustee may not actually possess the discretion suggested by the transitional rule. The 1931 Uniform Principal and Income Act, which Oklahoma adopted in 1941, applied to trusts created before its effective date as long as that application did not deprive persons of property without due process of law under either the Federal or Oklahoma Constitution.[235] Shortly after its enactment, the Oklahoma Supreme Court determined that applying the 1931 Act to an existing trust would effectively increase royalty payments to the income beneficiary and reduce the amount distributed to the vested remaindermen upon the trust's termination.[236] The court held that the statute as applied to the trust was unconstitutional because it deprived the remainder beneficiaries, against their consent, of a vested estate.[237] If the application of section 175.411 similarly affects vested interests in existing trusts, courts may require the trustee to account for oil and gas receipts in the same manner used prior to November 1, 1998.[238]

Finally, the express terms of the trust may provide for a different allocation of receipts from mineral interests.[239] In this regard, granting the trustee discretion to allocate receipts from natural resources to either principal or interest likely overrides the application of the OUPIA.[240] The question remains whether the generic and boilerplate authority to allocate receipts and disbursements between income and principal is sufficient to preempt the application of section 175.411. Although not yet addressed by courts, the

234. If a trust was created prior to November 1, 1998, the trustee appears to have authority to allocate receipts from some mineral interests in accordance with the OUPIA and receipts from other mineral interests in the manner used prior to the effective date. In practice, it is unlikely that a trustee would make this election on an interest-by-interest basis. Similarly, if a settlor contributes mineral interests after November 1, 1998, to a preexisting trust, the trustee may use either allocation method, although an argument can be made that the contribution of additional assets to a trust creates a new trust with respect to those additional assets for purposes of applying section 175.411.

235. Oklahoma Trust Act, ch. 4, § 54, 1941 Okla. Sess. Laws 265; *see* 60 OKLA. STAT. § 175.53 (1991).

236. Franklin v. Margay Oil Corp., 1944 OK 316, ¶ 87, 153 P.2d 486, 502.

237. *Id.* The *Franklin* court did not address the result if the remainder interest was contingent rather than vested.

238. The trustee also would have serious public relations problems if it notified income and remainder beneficiaries that it was exercising its discretion to modify the allocation of oil and gas receipts. This practical consideration itself might effectively eliminate the trustee discretion to adopt the allocation scheme contained in section 175.411 for existing trusts.

239. 60 OKLA. STAT. § 175.411(D) (2001).

240. The provision itself states that the Act does not apply if the trust document grants the trustee discretionary authority to allocate receipts. *See id.*

result probably will depend on whether that language is sufficient to override other provisions of the OUPIA.[241] The allocation rules set forth in section 175.411 are also subservient to sections 175.403 and 175.408.[242] In other words, if the trustee determines that it is in the best interests of all beneficiaries, it can account separately for oil and gas royalties, allocating receipts to principal as necessary for the reasonably foreseeable needs of the business activity.[243] Also, if the amounts involved are insubstantial, the trustee may allocate the entire receipt to principal.[244]

(4) Receipts from Timber

Section 175.412 applies to receipts from the sale of trees and by-products from harvesting and processing trees without regard to the kind of trees that are cut or when they are cut relative to their maturity. It also applies to the sale of Christmas trees and other ornamental trees.[245] The OUPIA does not, however, preclude a tenant in possession of the real estate from using wood for personal purposes such as for firewood and fence posts.[246]

Section 175.412 directs the trustee to allocate net receipts[247] from the sale of timber to income to the extent that the amount of timber removed from the land does not exceed the estimated growth rate of the timber during any period in which a beneficiary has a mandatory income interest.[248] If the amount of timber removed exceeds the estimated rate of growth, the OUPIA allocates the excess to principal.[249] This rule applies whether the trust owns the land and the receipt is from a third person who is harvesting timber and by-products

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241. For a detailed discussion, see *supra* Part II.A.

242. *See* 60 OKLA. STAT. §§ 175.403(C)(5), 175.408 (2001); UNIF. PRINCIPAL & INCOME ACT § 411 cmt. (amended 1997), 7B U.L.A. 174 (2000).

243. *See* 60 OKLA. STAT. § 175.403 (2001).

244. *See id.* § 175.408.

245. UNIF. PRINCIPAL & INCOME ACT § 412 cmt. (amended 1997), 7B U.L.A. 176 (2000). Prior Oklahoma law treated timber the same as other natural resources, and, regardless of the nature of the receipt, allocated 80% to income and 20% to principal. 60 OKLA. STAT. § 175.33 (1991). The enactment of the 1997 Uniform Act will result in a greater amount of timber receipts being allocated to principal. Evidently this reallocation of trust income and the resulting effect on trustee fees was not as troubling to Oklahoma banks and trust companies as was the uniform provision relating to oil and gas, *see supra* note 226 and accompanying text, which may be partially attributable to the transitional rule contained in section 175.412(D).

246. UNIF. PRINCIPAL & INCOME ACT § 412 cmt. (amended 1997), 7B U.L.A. 177 (2000).

247. "Net receipts" is a defined term.

248. 60 OKLA. STAT. § 175.412(A)(1) (2001). Section 175.102(7) defines mandatory income interest as "the right of an income beneficiary to receive net income that the terms of the trust require the fiduciary to distribute." It does not include a right to the trust's income that the trustee may distribute in its discretion.

249. *Id.* § 175.412(A)(2).

pursuant to a contract or whether the trust leases the land and the receipt is from the sale of products the trust harvests.[250] It also applies regardless of whether the settlor was harvesting timber or contracted to have a third person harvest timber before the real estate became a trust asset.[251]

For purposes of applying this test, the trustee determines both the amount of timber removed and the rate of growth "based on methods customarily used for the kind of timber involved."[252] Oklahoma enacted section 412 of the 1997 Uniform Act without revision.[253] The legislature amended this provision in 1999 to permit the trustee to estimate the timber's rate of growth.[254] Although the amendment presumably slightly lowers the standard of care that applies to the trustee's determination, it is unclear whether it will actually reduce the trustee's fiduciary obligations.[255]

The sale of timber and timber by-products must be distinguished from the sale of standing timber. Historically, courts have treated the sale of standing timber as the transfer of an interest in real estate that grants the purchaser the right of ingress and egress for a limited time to remove the trees.[256] As a result, the sale of standing timber is more closely related to the sale of a principal asset than the sale of an annual crop. Accordingly, the OUPIA allocates the net receipts from the sale of standing timber exclusively to principal.[257]

The allocation rules set forth in section 175.412(A) and discussed above apply only to the "net receipts" from the sale of timber and related products. Before allocating receipts between income and principal, the trustee must transfer to principal an amount otherwise allocable to income to reimburse the principal account for the removal of the nonreplaceable asset.[258] This rule

250. *Id.* § 175.412(A)(3).

251. *Id.* § 175.412(C). The OUPIA clearly negates the open-mine doctrine as applied to timber, although no prior Oklahoma case on point exists.

252. UNIF. PRINCIPAL & INCOME ACT § 412 cmt. (amended 1997), 7B U.L.A. 177 (2000).

253. Oklahoma Uniform Principal & Income Act, ch. 115, § 21, 1998 Okla. Sess. Laws 341.

254. Act of June 10, 1999, ch. 419, § 3, 1999 Okla. Sess. Laws 1982-83.

255. The legislature enacted this change in conjunction with the amendments to section 175.411. Because professional trustees actively sought the amendment to section 175.411, one must conclude that those same trustees somehow believed that the changes to section 175.412 reduced their potential exposure to liability. It is impossible to determine whether their fears were well grounded without first discerning the methods customarily used by the timber industry to estimate growth rates.

256. *See, e.g.*, Dierks Lumber & Coal Co. v. Fry, 1950 OK 242, ¶ 7, 223 P.2d 113, 115. Contracts for the sale of standing timber are similar to oil and gas leases, which Oklahoma law also treats as an interest in real estate. The Oklahoma Supreme Court made this precise analogy in *Dierks*. *Id.*

257. 60 OKLA. STAT. § 175.412(A)(2) (2001).

258. *Id.* § 175.412(A)(2), (B). Depletion for trust accounting purposes must be distinguished

does not apply to the sale of standing timber because those receipts are already allocable to principal.[259] In addition, "to the extent that the amount of timber removed . . . exceeds the estimated rate of growth," the OUPIA also allocates the excess to principal.[260] Thus, the rule can only affect those receipts otherwise allocated to income.

Regarding receipts that do not exceed the timber's estimated rate of growth, the rule initially seems redundant. As discussed above, the OUPIA views timber as a renewable resource, similar to farm crops. If the trust plants new trees to replace the harvested timber, there should be no depletion allowance for trust accounting purposes because the asset has been (or more accurately, will be) replaced.[261] To the extent that the trust does not replant the trees, however, the timber becomes a wasting asset. In this case, the trustee must allocate a portion of the receipts to principal, even though the rate of timber removal does not exceed the estimated growth rate.

The OUPIA generally applies to all trusts and estates existing on November 1, 1998, except as otherwise expressly provided in the governing instrument.[262] As with natural resources, a specific transitional rule applies to receipts from the sale of timber. If the trust existed on November 1, 1998, the trustee may allocate receipts from timber in accordance with section 175.412 or in the manner used by the trustee prior to the provision's effective date.[263] If the trust is established after the OUPIA's effective date, the trustee must allocate receipts from timber in accordance with the OUPIA.[264]

As in the case of receipts from other natural resources within the scope of section 175.411, the express terms of the trust also may provide for a different allocation.[265] If the trust instrument grants the trustee discretion to allocate

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from depletion for tax purposes. Timber is a depletable resource within the meaning of § 611(a) of the Internal Revenue Code. For a discussion of the depletion of timber for federal income tax purposes, see JOHN S. DZIENKOWSKI & RODERT J. PERONI, NATURAL RESOURCE TAXATION 326-28 (1988). *See also* Treas. Reg. § 1.611-3 (as amended in 2003).

259. 60 OKLA. STAT. § 175.412(A)(2) (2001).

260. *Id.*

261. In this case, a trustee should treat the cost of replanting the timber as a charge against income. *See id.* § 175.501(3). The net effect preserves the principal for the remainder beneficiaries, the primary purpose of a depletion allowance.

262. *See id.* § 175.602.

263. *Id.* § 175.411(D).

264. The transitional rule that applies to timberland is the same as the transitional rule that applies to mineral interests. As previously discussed, it is also possible that a trustee may not have the discretion that the transitional rule seems to grant with respect to timber owned by a trust on the Act's effective date because retroactively changing the beneficiaries' vested interests may be unconstitutional. *See* Franklin v. Margay Oil Corp., 1944 OK 316, ¶ 86, 153 P.2d 486, 502.

265. 60 OKLA. STAT. § 175.412(A) (2001).

receipts from timber to either principal or interest, the instrument overrides the application of section 175.412.[266] Whether the generic authority to allocate receipts and disbursements between income and principal is sufficient to preempt the application of section 175.412 is an open question. The outcome may depend on whether that language is sufficient to override other provisions of the OUPIA. The allocation rules set forth in section 175.412 are also subservient to sections 175.403 and 175.408.[267] If the trustee determines that doing so is in the best interests of all beneficiaries, it can account separately for timber receipts, allocating receipts to principal as necessary for the reasonably foreseeable needs of the business activity.[268] Again, if the amounts involved are insubstantial, the trustee may allocate the entire receipt to principal.[269]

(5) Receipts from Sale of Property Including Unproductive Property

In 1995, Oklahoma enacted the Uniform Prudent Investor Act,[270] which evaluates a trustee's investment strategy "in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust."[271] Thus, the trustee has discretion to invest in assets that do not produce current income to the extent those investments are consistent with the trustee's overall investment strategy.

Prior law deemed "unproductive" individual assets that did not generate at least a 1% return.[272] When a trust sold those assets, prior law required the trustee to treat a portion of the proceeds as delayed income in accordance with a complicated formula.[273] Because the investment focus has changed to overall trust return, that provision no longer serves a useful purpose, and the Oklahoma legislature repealed that section in 1998 with the enactment of the OUPIA.[274]

Except in the case of trusts that qualify for the marital deduction for federal transfer tax purposes, the OUPIA treats as principal proceeds from the sale or

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266. The provision itself states that the Act does not apply if the trust document grants the trustee discretionary authority to allocate receipts. *See id.* § 175.411(D).

267. *See id.* §§ 175.403(C)(5), 175.408; UNIF. PRINCIPAL & INCOME ACT § 412 cmt. (amended 1997), 7B U.L.A. 177 (2000).

268. *See* 60 OKLA. STAT. § 175.403(B) (2001).

269. *See id.* § 175.408.

270. Oklahoma Uniform Prudent Investor Act, ch. 351, 1995 Okla. Sess. Laws 1841 (codified at 60 OKLA. STAT. §§ 175.60-175.72 (2001)).

271. 60 OKLA. STAT. § 175.62(B) (2001).

272. 60 OKLA. STAT. § 175.35(A) (1991).

273. *See generally id.* § 175.35.

274. Oklahoma Uniform Principal & Income Act, ch. 115, § 33, 1998 Okla. Sess. Laws 346.

disposition of assets.[275] The OUPIA makes no allocation to income because the trustee has authority to make adjustments between principal and income if it manages the trust assets as a prudent investor.[276] Thus, if an asset that does not produce current income appreciates in value during the period in question, the trustee must consider the amount of that increase in determining whether it should adjust between principal and income, increasing the amount distributable to the income beneficiaries.[277]

Neither the OUPIA nor the Uniform Prudent Investor Act obviates an income beneficiary's common law right to require the trustee to make property productive.[278] The OUPIA's comments provide insight into how future court rulings might interpret it:

> As the law continues to develop in this area, the duty to make property productive of current income in a particular situation should be determined by taking into consideration the performance of the portfolio as a whole and the extent to which a trustee makes principal distributions to the income beneficiary under the terms of the trust and adjustments between principal and income under Section 104 of this Act.[279]

For a trust to qualify for the marital deduction for either federal gift or estate tax purposes, the surviving spouse generally must be entitled to all of the trust's income for life.[280] Treasury regulations provide that, for an income interest to qualify, the surviving spouse must be entitled to "substantially that

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275. 60 OKLA. STAT. § 175.413(B) (2001). Although the section is entitled "Property Not Productive of Income," it allocates proceeds from the sale of all assets to principal, regardless of the amount of income they generate. *Id.*

276. *Id.* § 175.104(A).

277. For a complete listing of all of the relevant factors, see *infra* Part III.B.3. If an unproductive asset does not increase in value, the trustee retains discretion to adjust between principal and income. Prior to the enactment of the OUPIA, the portion of the sales price of an unproductive asset allocated to income could not exceed the asset's appreciation while it was owned by the trust. 60 OKLA. STAT. § 175.35(B) (1991).

278. *See* UNIF. PRINCIPAL & INCOME ACT § 413 cmt. (amended 1997), 7B U.L.A. 178-79 (2000).

279. *Id.*

280. A spouse's interest in a trust is generally a terminable interest within the meaning of § 2523(b) or § 2056(b)(1) of the Internal Revenue Code. This, however, is not always the case. For example, a trust that grants discretion to the trustee to pay income to the surviving spouse during her life and which becomes payable to her estate upon death qualifies for the marital deduction because no interest passes to a person other than the surviving spouse. Treas. Reg. § 20.2056(c)-2(b)(1)(iii) (as amended in 1994). If it is a terminable interest, it must satisfy the income distribution requirements of § 2056(b)(5) or § 2056(b)(7)(B)(ii) of the Internal Revenue Code.

degree of beneficial enjoyment of the trust property . . . the principles of the law of trusts accord to a person who is unqualifiedly designated as the life beneficiary of a trust."[281] The trust ownership of unproductive property does not preclude a marital deduction. If the amount distributed to the surviving spouse is insufficient to provide the beneficial enjoyment required by the regulations, however, the spouse must be authorized to require the trustee to make the property productive, to convert property within a reasonable period of time, or to allocate amounts from principal to income as authorized by section 175.104(A).[282]

If the value of the life estate or remainder interest is determined actuarially for federal estate or gift tax purposes, the regulations also require that the income beneficiary must have the right to compel the trustee to make the trust property productive.[283] The use of actuarial tables to value trust interests is premised on the belief that the trust will yield an expected rate of return. The total return approach adopted by the Uniform Prudent Investor Act, coupled with the power of the trustee to make adjustments under section 175.104 from principal to income, should achieve the same result.[284] Until it is determined how the OUPIA interacts with the Internal Revenue Code, however, trust instruments should authorize beneficiaries to insist upon the acquisition of income-producing assets if the settlors desire to value trust interests under § 7520 of the Internal Revenue Code.[285]

281. Treas. Reg. § 20.2056(b)-5(f)(1) (as amended in 1994). For a detailed discussion of the income rights that the spouse must possess, see Treas. Reg. § 20.2056(b)-5(f) (as amended in 1994).

282. Because the determination of the marital deduction is made at the time of the gift or at the time of death, the spouse's failure to require the trustee to make the property productive or to transfer amounts from principal to income should not jeopardize the allowance of the marital deduction. The spouse, however, may be making an annual gift to the remainder beneficiaries of the foregone income interest.

283. Treas. Reg. § 20.7520-3(b)(2)(v), examples 1 and 2 (as amended in 1996).

284. As noted above, the uniform acts do not preempt "existing state law regarding the income beneficiary's right to compel the trustee to make [trust assets] productive." UNIF. PRINCIPAL & INCOME ACT § 413 cmt. (amended 1997), 7B U.L.A. 178 (2000). In the future, however, courts should look to the performance of the trust's investment as a whole before requiring that an individual asset be sold. *Id.* at 178-79.

285. The drafters of the 1997 OUPIA could have ensured compliance with the regulations by expanding the scope of section 175.413(A) to include trusts with interests valued in accordance with § 7520 of the Internal Revenue Code. The drafters failed to do so, probably influenced by the fact that these trusts may already be in compliance and the fact that the risk of noncompliance is significantly less than in the marital deduction arena.

(6) Receipts from Derivatives and Options

The inventiveness of the financial world has resulted in the addition of two specific provisions in the 1997 Uniform Act. Receipts from derivatives and options fall within the scope of section 175.414, and receipts from asset-backed securities fall within the scope of section 175.415. Historically, trustees may have considered these types of financial instruments too speculative for trust investment. Now, their purchase might be acceptable within the "total return" investment style.[286]

The OUPIA defines "derivative" to mean

> a contract or financial instrument [or any combination] which gives a trust the right or obligation to participate in some or all changes in the price of a tangible or intangible . . . group of assets, or changes in a rate, an index of prices or rates, or other market indicator for an asset or a group of assets.[287]

According to its comments, the drafters purposely defined a derivative in general terms in hopes that it could embrace financial products that may be introduced in the future.[288] The drafters clearly intended the definition to include the most common financial instruments so considered today, including forwards, futures, swaps, options embedded in derivatives, and similar instruments.

Pursuant to section 175.414(B), a trustee generally must allocate to principal any receipts from derivatives or disbursements made in connection with them.[289] For purposes of this rule, the OUPIA does not treat a gain or loss resulting from the trustee marking securities to market value or to another value as a transaction in a derivative financial instrument.[290] If a trustee receives property other than cash on the settlement of a derivatives transaction, the OUPIA also treats that property as principal under section 175.404(2).[291]

The OUPIA allocates to principal receipts from the sale of options and gains or losses realized on the exercise or settlement of options.[292] Thus, if the trustee

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286. C. Boone Schwartzel, *Is the Prudent Investor Rule Good for Texas?*, 54 BAYLOR L. REV. 701, 731-32 (2002).

287. 60 OKLA. STAT. § 175.414(A) (2001).

288. UNIF. PRINCIPAL & INCOME ACT § 414 cmt. (amended 1997), 7B U.L.A. 180-81 (2000). For a comprehensive definition of derivative, see ACCOUNTING FOR DERIVATIVE AND SIMILAR FINANCIAL INSTRUMENTS AND FOR HEDGING ACTIVITIES (Exposure Draft) (Fin. Accounting Standards Bd. June 20, 1996).

289. 60 OKLA. STAT. § 175.414(B) (2001).

290. UNIF. PRINCIPAL & INCOME ACT § 414 cmt. (amended 1997), 7B U.L.A. 181 (2000).

291. *See id.*

292. 60 OKLA. STAT. § 175.414(C) (2001).

grants to a third person a call, which is an option to buy property from the trust at a set price in the future, the OUPIA allocates to principal the amount the trust receives for the sale of that option. If the third person subsequently exercises the call, the OUPIA also allocates to (or charges against) principal, the gain (or loss) on the transaction. Similarly, if the trustee grants a third person the right to put property to the trust at a set price in the future, the OUPIA treats the amount received by the trustee as principal. If the third person subsequently requires the trustee to purchase the asset, the trustee must charge the cost against principal. The same rules apply to the trust's acquisition of an option to buy property for the trust or an option to sell an asset the trust owns.

Although options typically involve securities and commodities, section 175.414 also applies to other types of financial instruments. For example, section 175.414(C) allocates to principal any amount the trust receives in connection with the sale to a third person of an option to purchase real estate owned by the trust.[293] However, it does not apply if the consideration received or given for the option is not cash or property.[294]

The trustee may elect to account separately for a business activity that includes the purchase and sale of derivatives as provided by section 175.403.[295] If the trustee determines that such an election best serves the interest of all beneficiaries, section 175.403(B) provides the allocation for receipts from the business authority.[296] The comments anticipate that "[i]f a trustee invests directly in derivatives to a significant extent," the trustee must account for the activity as a business under section 175.403.[297] There is no similar presumption, however, with respect to trading in options.[298]

(7) Receipts from Asset-Backed Securities

For purposes of section 175.415, an asset-backed security is an arrangement

293. UNIF. PRINCIPAL & INCOME ACT § 414 cmt. (amended 1997), 7B U.L.A. 181 (2000).

294. *Id.* According to the comments, this would include "cross-options granted in a buy-sell agreement between owners of an entity." *Id.*

295. This authority is granted in section 175.403(C)(7) and acknowledged in section 175.414(B).

296. 60 OKLA. STAT. § 175.403(A) (2001).

297. UNIF. PRINCIPAL & INCOME ACT § 414 cmt. (amended 1997), 7B U.L.A. 181 (2000).

298. Section 175.414(B) specifically acknowledges that a trustee may account for derivative trading as a business under section 175.403. The statute is silent with respect to whether a trustee may account for option trading separately as a business activity. Section 175.403(C), however, sets forth those activities for which a trustee may account separately, and section 175.403(C)(7), without limitation, refers to activities described in section 175.414. Compare this with the other activities listed in section 175.403(C), which are described rather than referenced by statute. It is also possible that the definition of "derivative" in section 175.414(A) is broad enough to include options discussed in section 175.414(C).

in which an investment trust acquires "debt obligations such as real estate mortgages, credit card receivables and auto loans" and sells interests in that trust to investors.[299] The term includes an "interest only" security, which limits the owner to interest or other current return generated by the collateral, and a "principal only" security, which gives the owner the right to receive only the principal payments.[300] The term also includes a security where investors may benefit from the security's increased value, but excludes payments that permit investors to participate in either the capital appreciation of an underlying security or in the interest or dividend return from a security.[301] The term does not include, however, deferred compensation and annuities within the meaning of section 175.409 or receipts from entities within the meaning of section 175.401.[302]

The OUPIA allocates to income that portion of any receipt from an asset-backed security that is classified as "interest or other current return," and allocates the remaining receipts to principal.[303] Under this rule, a trustee must allocate all receipts from an interest-only security to income, and must allocate all receipts from a principal-only security to principal, which may cause distortion when computing the trust's net income. As in the case of the OUPIA's treatment of bond premiums and discounts, however, the drafters felt that over time the distortions would offset.[304]

If the trust receives in one accounting period a payoff for its entire interest in an asset-backed security, the OUPIA allocates the entire receipt to principal.[305] If the payment is periodic and will liquidate the trust's interest in the security over two or more accounting periods, however, the trustee must allocate 10% of the payment to income."[306] Note that section 175.415(C) applies only to liquidating payments. Thus, the OUPIA allocates no portion of a principal receipt, including a receipt from a principal-only security, to income pursuant to section 175.415(C) unless it is one of a series of planned payments that completely liquidates the security.

299. UNIF. PRINCIPAL & INCOME ACT § 415 cmt. (amended 1997), 7B U.L.A. 182 (2000).

300. 60 OKLA. STAT. § 175.415(A) (2001).

301. UNIF. PRINCIPAL & INCOME ACT § 415 cmt. (amended 1997), 7B U.L.A. 182 (2000).

302. Section 175.415(A) provides that the rule with respect to asset-backed securities does not apply to entities described in section 175.401, and section 175.401(A) provides that the rule with respect to entities does not apply to asset-backed securities described in section 175.415. Although this appears to create a circular analysis, section 175.415 is more specific and should control over section 175.401.

303. 60 OKLA. STAT. § 175.415(B) (2001).

304. The trustee may also adjust between principal and income pursuant to section 175.104.

305. 60 OKLA. STAT. § 175.415(C) (2001).

306. *Id.*

2. Allocation of Disbursements During Administration

Article 5 sets forth the rules concerning the allocation of disbursements between income and principal. As in the case of the receipts, the OUPIA only provides for default rules. The express terms of the trust instrument control the allocation of disbursements to the extent they are inconsistent with the OUPIA.[307] Also, if the terms of the trust instrument and the OUPIA do not provide guidance, the OUPIA directs the trustee to allocate the disbursement against principal.[308]

a) Basic Disbursements from Income and Principal

(1) Disbursement from Income

Section 175.501 lists expenses charged against income. Special rules in section 175.201, however, apply to terminating income interests and have priority over section 175.501.[309]

Because some annual expenses benefit all of the trust's beneficiaries, the OUPIA allocates against income 50% of (1) the regular trustee's commission, (2) compensation paid to any investment advisor or custodial service provider, and (3) expenses for "accountings, judicial proceedings, or other matters that involve both the income and remainder interests."[310] The OUPIA apportions regular trustee fees between income and principal regardless of whether the fees are tied by percentage to principal, income, or the total res.[311] A trustee must allocate the remainder of these expenses against principal.[312]

The OUPIA charges the other ordinary expenses incurred in administering, managing, or preserving the trust property, and the distribution of income, exclusively against income.[313] This includes interest the trust pays, regularly recurring taxes assessed against principal, and expenses of any matter that primarily concerns the income interest. Regularly recurring taxes include ad

307. *Id.* § 175.103(A)(1).

308. *Id.* § 175.103(A)(4).

309. The introductory language in section 175.501 recognizes this priority. For a discussion of terminating income interests, see *infra* Part III.C.

310. 60 OKLA. STAT. § 175.501(A)(1)-(2) (2001). This represents a major change from prior law. The 1931 Uniform Act charged most trustee fees against income. *See* 60 OKLA. STAT. § 175.36(A) (1991). The 1931 Act only charged trustee fees "computed upon distributions of principal, [and] cost[s] of investing or reinvesting principal" against principal. *See id.* § 175.36(B).

311. UNIF. PRINCIPAL & INCOME ACT § 501 cmt. (amended 1997), 7B U.L.A. 183 (2000).

312. 60 OKLA. STAT. § 175.502(A)(1) (2001).

313. *Id.* § 175.501(A)(3).

valorem taxes imposed on real and personal property,[314] but do not include income taxes, which a trustee must apportion in accordance with section 175.505.

The OUPIA charges insurance premiums against income if two requirements are satisfied. First, the insurance must cover the loss of a principal asset, its use, or the income it generates.[315] Second, the payments must be recurring.[316] Property insurance on a building and business interruption insurance meet both requirements. Although title insurance purchased at the time of the acquisition of property provides coverage against the loss of a principal asset, it is not a recurring expense. As a result, the OUPIA charges its cost against principal.[317] Although life insurance premiums may be recurring, they do not provide coverage for the loss of a trust asset or for the loss of income. Similarly, the OUPIA charges these premiums against principal.[318]

In addition to those expenses listed in section 175.501, there may be other charges against a trust's income. The trustee must charge a portion of the entity's income tax obligation against income.[319] The OUPIA also authorizes the trustee to transfer amounts from income to principal to establish a reserve for depreciation under section 175.503 and to reimburse the principal for expenditures described in section 175.504. Finally, the trustee may transfer amounts from income to principal pursuant to section 175.104 if it is fair and reasonable to all of the trust's beneficiaries.

(2) Disbursements from Principal

Disbursements that a trustee does not charge against income, by necessity, must be charged against principal. The OUPIA itemizes in section 175.502 the expenditures that a trustee must charge against principal. If the terms of the trust instrument and the OUPIA do not establish a rule covering the allocation of an expense, the OUPIA directs the trustee to charge the disbursement against principal.[320]

314. UNIF. PRINCIPAL & INCOME ACT § 501 cmt. (amended 1997), 7B U.L.A. 183 (2000).

315. 60 OKLA. STAT. § 175.501(4) (2001).

316. *Id.*

317. Section 175.502(A)(5) charges title insurance against principal. UNIF. PRINCIPAL & INCOME ACT § 501 cmt. (amended 1997), 7B U.L.A. 183 (2000).

318. 60 OKLA. STAT. § 175.502(A)(5) (2001).

319. *Id.* § 175.505.

320. *Id.* § 175.103(A)(4).

The portion of the trustee's regular commission and other ordinary expenses that is not charged against income[321] is charged against principal.[322] Thus, the OUPIA charges 50% of those expenses relating to both income and principal against principal, regardless of how they are computed.[323]

A portion of the trustee's compensation may be directly attributable to the acceptance of assets, the distribution of assets, or the trust's termination. If these fees are "calculated on principal," a trustee must charge them against principal.[324] For example, if a trustee charges 1% of the value of the assets to make distribution to the trust's beneficiaries on termination, the OUPIA treats the fee as a principal disbursement. Neither the statute nor the comments define the quoted language. It is unlikely, however, that the provision requires the trustee to express the fees as a percentage of the principal involved. Rather, the legislative intent appears to distinguish fees attributable directly to the enumerated principal transactions from a trustee's regular compensation[325] and from fees incurred in connection with income distributions.[326]

A trustee must also charge expenses incurred in preparing property for sale against principal.[327] Repairs made to property that the trustee intends to sell are principal disbursements because they presumably will increase the sale price, an entirely principal receipt.[328] A trustee must distinguish these expenditures from ordinary repairs to property that the trustee intends to retain, which the OUPIA views as increasing the amount of income the property generates, therefore appropriately charging them against income.[329]

If the trustee makes a payment on trust debt, the OUPIA charges the principal portion of the payment against principal[330] and the portion representing interest against income.[331] The economic reality of allocating a debt payment between income and principal presumes that the debt carries a market rate of interest; obligations that fail to carry a market rate of interest trigger complicated income tax rules relating to the recharacterization of

321. *Id.* § 175.501(1)-(2).

322. *Id.* § 175.502(A)(1).

323. UNIF. PRINCIPAL & INCOME ACT § 501 cmt. (amended 1997), 7B U.L.A. 183 (2000); *see also supra* note 310 and accompanying text.

324. 60 OKLA. STAT. § 175.502(A)(2) (2001).

325. The OUPIA charges these fees equally between income and principal. *Id.* §§ 175.501(1), 175.502(A)(1).

326. The OUPIA charges these expenditures against income. *Id.* § 175.501(3).

327. *Id.* § 175.502(A)(2).

328. *Id.* § 175.404(2).

329. *Id.* § 175.501(3).

330. *Id.* § 175.502(A)(3).

331. *Id.* § 175.501(3).

payments between income and principal.[332] In the fiduciary accounting setting, the trustee should charge the entire payment on an interest-free obligation against principal, and, if appropriate, adjust between principal and income.[333]

The trustee should also charge against principal the expenses of a proceeding that primarily involves the principal, including actions to protect its res, and actions to clear or protect title to property that the trust owns.[334] In addition, a trustee should charge costs incurred in connection with an action to interpret a trust instrument against principal, even if the disagreement involves language relating to income distributions.

If the expenses relate to the determination of the amount of net income rather than the interpretation of the trust instrument, a trustee might initially conclude that the action primarily concerns the income interest and should be charged against income as provided in section 175.501(3). The action by necessity affects both the income and principal interests, and if there is a reasonable basis for the suit, courts may be inclined to apportion the costs rather than to charge them exclusively against income.[335] If, on the other hand, an income beneficiary files an action contesting the computation of net income without probable cause, a trustee has sufficient authority to charge the related expenses against income.[336]

The OUPIA charges against principal insurance premiums other than recurring premiums on coverage for the loss of a principal asset or the loss of income from, or use of, an asset,[337] as well as all transfer taxes that are payable from trust assets.[338] This includes federal estate, gift, and generation-skipping transfer taxes and state estate, inheritance, and gift taxes. Further, the OUPIA

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332. *See* I.R.C. § 483 (2000).

333. *See* 60 OKLA. STAT. § 175.104 (2001). There is a separate issue with respect to whether the trust document authorizes the trustee to make loans that do not carry a market rate of return.

334. *Id.* § 175.502(A)(4).

335. In *Templeton v. Peoples National Bank of Washington*, 722 P.2d 63, 64 (Wash. 1986), the income beneficiary commenced an action to determine whether a trustee should allocate to income or principal received by a trust. The Washington Supreme Court held that the trial court had discretion to charge expenses incurred by the trust against both income and principal. *Id.* at 67. The principal issue, however, involved whether the trust instrument was ambiguous so that the court could use extrinsic evidence to interpret its terms. *Id.* at 65.

336. 60 OKLA. STAT. § 175.501(3) (2001). Similarly, if a principal beneficiary files an action to contest the amount of the income distribution without probable cause, a trustee may be tempted to charge all expenses against principal, relying on section 175.502(A)(4) as authority.

337. *Id.* § 175.502(A)(5). The OUPIA charges against income recurring premiums on coverage "for the loss of a principal asset or the loss of income from or use of the asset." *Id.* § 175.501(4).

338. *Id.* § 175.502(A)(6).

charges against principal penalties assessed with respect to transfer taxes,[339] but it charges *interest* on underpaid taxes against income.[340] Special rules apply to the apportionment of income taxes.[341] In certain circumstances, tax elections and other decisions the trustee makes may affect the economic interests of a trust's beneficiaries. Section 175.506 authorizes a trustee to adjust between principal and income to account for the shifting of economic interests and tax benefits.[342]

The OUPIA contains a very broad provision directing the trustee to charge all environmental expenses against principal[343] on the assumption that they are usually extraordinary.[344] By charging these expenses against principal, the cost is borne by both the income and remainder beneficiaries.[345] These expenses include

> [d]isbursements related to . . . reclamation, assessing environmental conditions, remedying and removing environmental contamination, monitoring remedial activities and the release of substances, preventing future releases of substances, collecting amounts from persons liable or potentially liable for the costs of those activities, penalties imposed under environmental laws or regulations and other payments made to comply with those laws or regulations, statutory or common law claims by third parties, and defending claims based on environmental matters.[346]

The OUIPA also charges against principal expenses incurred to comply with environmental laws, including consulting costs and other expenses generated by an administrative or judicial proceeding.[347]

In a few instances, it may be appropriate to charge environmental expenses against income, as where the trustee is carrying on a business "that uses or

339. *Id.*

340. *See id.* § 175.501(3).

341. *See id.* § 175.505.

342. *Id.* § 175.506(A).

343. *Id.* § 175.502(A)(7).

344. UNIF. PRINCIPAL & INCOME ACT § 501 cmt. (amended 1997), 7B U.L.A. 184 (2000).

345. *Id.* If the OUPIA charged environmental expenses against income, the income beneficiary would be solely responsible for their payment.

346. 60 OKLA. STAT. § 175.502(A)(7) (2001). The scope of the provision is limited to environmental claims. The drafters "decided that it was not necessary to broaden this provision to [include] other [nonenvironmental] expenditures made under compulsion of governmental authority." UNIF. PRINCIPAL & INCOME ACT § 502 cmt. (amended 1997), 7B U.L.A. 184 (2000).

347. UNIF. PRINCIPAL & INCOME ACT § 502 cmt. (amended 1997), 7B U.L.A. 185 (2000). This includes all burdens "imposed as the result of an administrative or judicial proceeding, even though [those] burden[s] [are] not formerly characterized as a penalty." *Id.*

sells toxic substances, in which case environmental cleanup costs would be a normal cost of doing business."[348] In these cases, the trustee may transfer amounts from income to reimburse principal for the expenditure as authorized in section 175.504 or may elect to account for the business separately as provided in section 175.403.

b) Transfers Between Income and Principal

(1) Allowance for Depreciation

The OUIPA generally allocates receipts from rental property to income.[349] If the trustee were to follow this rule exclusively, the income beneficiary would be advantaged at the expense of the remainder beneficiaries. The OUPIA grants the trustee discretion to transfer from income to principal a reasonable amount each year to reimburse the principal for the effect of depreciation. Under general accounting principles, this transfer establishes a "reserve" for depreciation and may be accompanied by an implication that the trustee will subsequently use the fund either to repair or replace the depreciating asset. The OUPIA does not require the trustee to hold amounts transferred from income to principal as a separate fund, and therefore avoids using this common terminology.[350]

For purposes of section 175.503, depreciation means "a reduction in value . . . of a fixed asset having a useful life" of over one year "due to wear, tear, decay, corrosion, or gradual obsolescence."[351] The provision clearly covers residential and commercial real estate. It also authorizes transfers from income to principal where the depreciating asset is more indirectly involved in the production of income. For example, if the trust were to operate a business, the trustee could transfer amounts from income to principal to reflect the reduction in value of all business assets even though each individual asset, by itself, does not generate receipts.[352]

The trustee is permitted, but not required, to exercise the discretion to reimburse principal for depreciation. By contrast, the 1962 Uniform Act

348. *Id.* at 184.

349. *See* 60 OKLA. STAT. § 175.405 (2001). The trustee may elect to account separately for rental property as provided in section 175.403.

350. *Id.* § 175.503(C).

351. *Id.* § 175.503(A).

352. It is likely that the trustee would elect to account separately for the business under section 175.403.

included mandatory language.[353] The drafters explain this change in the comments:

> [The 1962 Uniform Act] provision has been resisted by many trustees, who do not provide for any depreciation for a variety of reasons. One reason relied upon is that a charge for depreciation is not needed to protect the remainder beneficiaries if the value of the land is increasing; another is that generally accepted accounting principles may not require depreciation to be taken if the property is not part of a business. The Drafting Committee concluded that the decision to provide for depreciation should be discretionary with the trustee.[354]

When exercising discretionary powers, including the power to transfer amounts from income to principal for depreciation, the duty of impartiality applies.[355]

The comments also acknowledge that the trustee may transfer income to principal to make principal payments on debt secured by the depreciable property.[356] Section 175.504(B)(4) grants the trustee authority to transfer amounts from income to principal to reimburse principal for mortgage payments to the extent that the amount transferred does not exceed the periodic payments.[357] If the trustee desires to reimburse principal for mortgage payments, it is perhaps more consistent with general fiduciary accounting principals to rely on the authority granted by section 175.504 rather than section 175.503, which relates to depreciation.

The OUPIA places several restrictions on the trustee's power to reimburse principal for depreciation. It precludes a trustee from transferring amounts from income to principal if the depreciable property is tangible personal

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353. The 1962 Uniform Act provided that a reasonable allowance for depreciation "shall be made against income." UNIF. PRINCIPAL & INCOME ACT § 13(a),(a)(2) (1962), 7B U.L.A. 232 (2000). Although the Oklahoma legislature never enacted the 1962 Act, the reason for the change in the 1997 Act is instructive with respect to interpreting the current provision.

354. UNIF. PRINCIPAL & INCOME ACT § 503 cmt. (amended 1997), 7B U.L.A. 185-86 (2000). In this regard, the 1997 Uniform Act may more closely correspond with the common law. Unless the trust instrument required that the trustee must establish a reserve, the prevalent view found no duty to establish a reserve. *See* BOGERT & BOGERT, *supra* note 207, § 829.

355. 60 OKLA. STAT. § 175.103(B) (2001); *see* UNIF. PRINCIPAL & INCOME ACT § 503 cmt. (amended 1997), 7B U.L.A. 186 (2000). The trust instrument may authorize the trustee to favor one or more beneficiaries at the expense of others. 60 OKLA. STAT. § 175.103(B) (2001).

356. UNIF. PRINCIPAL & INCOME ACT § 503 cmt. (amended 1997), 7B U.L.A. 186 (2000). The OUPIA charges against principal disbursements representing the principal portion of loan payments. *See* 60 OKLA. STAT. § 175.502(A)(3) (2001).

357. 60 OKLA. STAT. § 175.504(B)(4) (2001).

property or residential real property used or enjoyed by a beneficiary.[358] A beneficiary-occupied house stills depreciates in value during the occupancy term, and the remainder beneficiary may receive an asset worth significantly less than when the settlor contributed it to the trust. The drafters have assumed, however, that the average settlor takes this into account and would not have intended that the interest of the income beneficiary (who, in most cases, is also the occupant) be diminished by transferring amounts from income to principal for depreciation.

The OUPIA generally determines an estate's net income in the same manner as a trust's.[359] An executor does not have discretion, however, to reimburse the principal account for depreciation that occurs during the estate's administration.[360] Because estates are intended to be open for only a limited period, this restriction does not materially disadvantage the remainder beneficiaries and does simplify the estate's management.

Finally, if the trustee elects to account for a business activity separately, as provided in section 175.403, the trustee determines to what extent it should retain cash receipts to acquire or replace fixed assets and other business needs.[361] The trustee treats the activity as a separate entity where the final allocation of cash receipts to income resembles the declaration of a corporate dividend.[362] In making this determination, the trustee should account for the reduction in value of the fixed assets as the result of depreciation, and no additional transfer from income to principal for depreciation is justified.[363]

(2) Reimbursement Transfers

After applying all of the other rules respecting the determination of a trust's net income, the trustee has discretion to transfer an appropriate amount from income to principal to reimburse principal for specific disbursements or to establish a reserve for anticipated future disbursements.[364] When exercising this discretionary power, the trustee must act impartially.[365] The trust instrument may limit this discretion if it authorizes the trustee to favor one or more beneficiaries at the expense of others. Further, the OUPIA authorizes

358. *Id.* § 175.503(B)(1).
359. *Id.* § 175.201(2).
360. *Id.* § 175.503(B)(2).
361. *Id.* § 175.403(B).
362. UNIF. PRINCIPAL & INCOME ACT § 403 cmt. (amended 1997), 7B U.L.A. 164 (2000).
363. 60 OKLA. STAT. § 175.503(B)(3) (2001).
364. *Id.* § 175.504(A). This power is similar to a trustee's authority to transfer amounts from income to principal to establish a reserve for depreciation, reimbursing principal for a wasting asset used to generate income.
365. *Id.* § 175.103(B); *see* UNIF. PRINCIPAL & INCOME ACT § 503 cmt. (amended 1997), 7B U.L.A. 186 (2000).

no adjustments from income to principal if the trustee anticipates being reimbursed for the principal disbursement by a third person.[366] Section 175.504 sets forth specific instances when adjustments may be appropriate. In most cases, the statute contemplates the trustee transferring from income to principal over several accounting periods.[367]

The purpose of section 175.504 is to regularize income distributions, permitting the income beneficiary to rely on a more consistent income stream.[368] Section 175.504 only grants this discretion until the income interest ends.[369] The trustee, however, may continue transfers from income to principal in the event that there are successive income interests.[370]

The first scenario in which the OUPIA authorizes a transfer from income to principal is when the trustee makes a large, nonrecurring disbursement from principal that is properly charged against income.[371] Section 175.504(B)(1) implicitly authorizes the trustee first to make the disbursement from principal. It then expressly authorizes the trustee to transfer amounts from income generated in the future to principal to reimburse the principal account. Because this is a discretionary power, the impartiality standard applies, based on what is fair and reasonable to all of the trust's beneficiaries.[372] There does not appear to be any requirement that the trustee fully reimburse the principal account.

The second type of principal disbursement that may give rise to an adjustment involves capital improvements to a principal asset, including changes or improvements to an existing asset, the construction of a new asset, or the payment of special assessments.[373] Similarly, a transfer from income

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366. 60 OKLA. STAT. § 175.504(B) (2001).

367. *Id.* § 175.504(A).

368. UNIF. PRINCIPAL & INCOME ACT § 504 cmt. (amended 1997), 7B U.L.A. 186 (2000). This is similar to the authority granted to a trustee to spread income distributions of unusual amounts "throughout a series of years" under prior Oklahoma law. 60 OKLA. STAT. § 175.36(C) (1991).

369. Section 175.102(6) defines an income interest to mean "the right of an income beneficiary to receive all or part of [the trust's] net income," regardless of whether the right to receive the income is mandatory or discretionary. 60 OKLA. STAT. § 175.102(6) (2001).

370. *Id.* § 175.504(C).

371. *Id.* § 175.504(B)(1). The example used in the statute relates to "extraordinary repairs." *Id.* Under section 175.501(3), a trustee must charge against income disbursements relating to "ordinary repairs." Major improvements to a building are generally charged against principal. *See id.* § 175.103(A)(4).

372. *See id.* § 175.103(B); UNIF. PRINCIPAL & INCOME ACT § 503 cmt. (amended 1997), 7B U.L.A. 186 (2000).

373. 60 OKLA. STAT. § 175.504(B)(2) (2001). Improvements within the scope of section 175.504(B)(2) should be distinguished from ordinary repairs, which the OUPIA charges against income. *Id.* § 175.501(3).

to principal may be appropriate if the trustee makes principal disbursements to prepare property for rental.[374] Property improvements generally result in increased earnings, which the OUPIA allocates to income.[375] Unless the trustee makes transfers in future accounting periods from income to reimburse principal, a portion of the principal would be converted for the benefit of the income beneficiary. In this regard, sections 175.504(B)(2) and (3) serve the same purpose as establishing a reserve for depreciation under section 175.503, and may, to that extent, be redundant. There are expenditures described above, however, that may not necessarily give rise to a depreciating asset and thus fall outside the scope of section 175.503.[376] Further, a trust prohibition against establishing a reserve for depreciation may not necessarily preclude the trustee from reimbursing principal for the types of expenditures described in sections 175.504(B)(2) and (3).[377]

The OUPIA also permits transfers from income to principal to the extent that there are principal distributions relating to periodic payments on obligations secured by principal assets.[378] If trust property is encumbered with a mortgage, the OUPIA charges the portion of the payment representing interest against the trust's income[379] and the portion representing principal against the trust's principal.[380] If the principal payment on the debt exceeds the amount transferred from income to principal for depreciation,[381] section 175.504(B)(4) grants the trustee discretion to transfer additional amounts from income to principal. In other words, the OUPIA gives trustees discretion to use trust income to make the entire principal payment if doing so is fair and reasonable to all of the trust's beneficiaries. The elimination of a mortgage obligation increases the amount that ultimately will pass to the remainder beneficiaries. Thus, under traditional fiduciary accounting principles, it seems

374. *Id.* § 175.504(B)(3). "Rental" includes the payment of tenant allowance, leasehold improvements, and real estate broker's commission. *Id.*

375. Section 175.405 provides that a trustee must allocate to income receipts from rental property.

376. Section 175.503(A) defines 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 (1) year." Paying a real estate agent a commission in connection with the rental of commercial property historically would be amortized over the term of the lease and technically would fall outside the scope of section 175.503 because it is not a fixed asset.

377. An express prohibition against establishing a depreciation reserve should control with respect to those expenditures described in sections 175.504(B)(2) and (3), which relate to the creation of depreciable assets, such as the construction of a new asset.

378. 60 OKLA. STAT. § 175.504(A)(4) (2001).

379. *See id.* § 175.501(3).

380. *See id.* § 175.502(A)(3).

381. *See id.* § 175.503.

unfair to the income beneficiaries to transfer amounts from income to reimburse principal for principal payments in excess of the reserve for depreciation or to reimburse all of the principal payment if the trust document does not authorize the trustee to establish a reserve for depreciation. On the other hand, the trustee can argue that the reduction of principal directly benefits the income beneficiary by reducing future interest payments and thus increasing future income distributions.[382] It will be interesting to see how trustees will exercise this discretion in practice.[383]

Finally, trustees have discretion to transfer income to principal if the trust makes disbursements relating to environmental matters described in section 175.502(A)(7).[384] The OUPIA normally allocates to principal disbursements related to environmental concerns.[385] In many situations, however, it is equitable for the income beneficiary to bear a portion of those expenditures. For example, a business may attempt to maximize current profits by discharging contaminants in an environmentally unfriendly manner. If the business had used more costly disposal techniques, the income beneficiaries' distributions would have been correspondingly reduced. In this situation, trustees should exercise their discretion to transfer amounts from income to principal.[386] In other cases, however, an adjustment would be unfair to the income beneficiaries. Assume that the trust received from the settlor real estate that had already been environmentally damaged. In this case, equity dictates that the principal should bear all reparation costs.

c) Effect of Taxation

(1) Income Taxes

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.[387] The trustee first must classify the trust's receipts as either income or principal in accordance with the rules set forth in sections 175.401 to

382. This argument, of course, lacks merit because the same argument applies with respect to any accumulation of income. Although reserves for depreciation are justifiable under traditional trust accounting principles, those reserves seem unrelated to principal payments on mortgages, and it is curious why the drafters decided to link the two concepts in section 175.504(B)(4).

383. This may be the type of discretion that trustees wish they did not possess.

384. 60 OKLA. STAT. § 175.504(B)(5) (2001).

385. *Id.* § 175.502(A)(7).

386. Although the trustee perhaps should limit the adjustment to the amount of "excess" income distributed in the past, it clearly has discretion to transfer either more or less than that amount to income.

387. 60 OKLA. STAT. § 175.505(A)-(B) (2001).

175.415. The trustee then reduces the receipts allocable to income by income distributions to beneficiaries for which the trust receives an income distribution deduction for federal income tax purposes.[388] Similarly, the trustee must reduce the principal receipts by deductible principal distributions. Thus, the allocation of the taxes between income and principal is interrelated with Subchapter J of the Internal Revenue Code.

Assume that under the terms of the governing instrument the trustee must distribute all income (other than capital gain recognized on the sale of principal assets) to the income beneficiary.[389] The trust's net income must be computed pursuant to the OUPIA, while the computation of the trust's taxable income must be computed pursuant to the Internal Revenue Code. In the rare event that these amounts are the same[390] or if the trust's taxable income is less than the amount that it must distribute to the income beneficiary, the trust will receive a deduction for distributions to the income beneficiary that is limited to the trust's distributable net income.[391] Assuming that the trust does not recognize any capital gain, the income distribution deduction will normally offset the trust's taxable income, and the trust will have no tax obligation.[392] If the trust's taxable income exceeds its distributable income, the trust's income distribution deduction will normally be less than its taxable income, and the trustee must charge the federal and state income tax paid on the trust's taxable income against the trust's accounting income.[393]

Although the rules set forth in sections 175.505(A), (B), and (D) appear simple, their precise application is puzzling. Assume that during 2001, a trust receives $8000 of interest income, recognizes $8000 of long-term capital gain

388. *See* I.R.C. §§ 651, 661 (2000). Assume, for example, that a trust must currently distribute income and that it recognizes a significant amount of capital gain allocable to principal. Because the trust receives an income distribution deduction for the amount distributed to its income beneficiary, the tax paid by the trust will be attributable to the capital gain and generally will be charged against principal.

389. A trustee normally allocates gain on the sale of a principal asset to principal and does not distribute it to an income beneficiary. *See* 60 OKLA. STAT. § 175.404(2) (2001).

390. This is seldom the case. For example, a trustee may deduct its fees for income tax purposes under § 212 of the Internal Revenue Code. For trust accounting purposes, however, sections 175.501 and 175.502(A)(1) charge one-half against income and one-half against principal.

391. *See* I.R.C. §§ 643(a), 651(b) (2000).

392. This example assumes that the trustee does not allocate any of the trust's taxable income receipts to principal for trust accounting purposes.

393. Because the trust's income tax return is not filed until the 15th day of the fourth month after the close of its taxable year, this charge will normally be made in the year after the year of receipt of the income items. *See* I.R.C. § 6072 (2000). This also avoids an interrelated computation that might result if the trustee makes the charge against income in the year of receipt.

on the sale of a trust asset, pays $2000 of trustee fees, and makes no distributions to beneficiaries. The trust's total tax obligation would be $3047.[394] Because the trustee allocates one-half of the receipts to income and one-half to principal, one might initially conclude that the trust should allocate the tax against the income and principal accounts equally.[395] This approach fails, however, to account for the favorable tax treatment that long-term capital gains enjoy.[396]

To address this problem, the trustee may decide to compute the tax on the interest income only, taking into the account the deduction for trustee fees. This amount is $1447, which the trustee would then allocate against income. The additional tax resulting from the recognition of capital gain would be $1600 ($3047 minus $1447). The trustee might decide, however, to first compute the tax on only the capital gain ($1000) that it would allocate against principal. It would attribute the remainder ($2047) to the receipt of the interest income. Note that all of the approaches reach different results because of the progressive nature of the rate table.[397]

This simple example raises an additional complication. For trust accounting purposes, sections 175.501 to 175.506 control the allocation of disbursements between income and principal. Because those sections allocate trustee fees equally against income and principal, it seems logical that the same rule should apply when allocating the income tax burden. The OUPIA, however, bases the allocation of taxes on income and principal receipts.[398] Although this may appear to grant the trustee discretion to reduce either income or principal receipts by deductions allowable to the trust, this should not be the case.

These problems would largely disappear if the law required the trustee to allocate the tax proportionately against income and principal receipts.[399] The tax allocated to income would equal the total tax times a fraction, with the

394. Because the trust made no distributions, it is a complex trust entitled to a $100 exemption. *See id.* § 642(b).

395. The drafters adopted this simplified approach with respect to income relating to interests in entities that the trust owns. *See* 60 OKLA. STAT. § 175.505(C) (2001).

396. *See* I.R.C. § 1(h) (2000).

397. In addition, long-term capital gains may be taxed at different rates depending on the nature of the gain and the amount of the trust's other income. *See id.*

398. For federal income tax purposes, trustees have significant flexibility in allocating deductions against different classes of income for purposes of computing distributable net income (DNI). *See* Treas. Reg. § 1.652(b)-3 (1960). The computation of DNI is critical in determining the amount and character of the income that the beneficiary must report. *See* I.R.C. §§ 652, 662 (2000).

399. Oklahoma adopted this approach, in part, with respect to the trust's payment of tax relating to interests in entities that the trust owns. *See* 60 OKLA. STAT. § 175.505(C) (2001).

numerator equal to the net income receipts (the total income receipts computed under the OUPIA reduced by income distributions for which the trust has received an income tax deduction) and the denominator equal to the sum of the net income receipts and net principal receipts (computed in the same manner as the net income receipts). A trustee would allocate the remainder of the tax to principal. Although small anomalies may occur in any one year, over an extended time period this approach would treat all beneficiaries equitably. In practice, it seems reasonable for trustees to adopt this simplified approach.[400]

If a trust owns an interest in an entity, the OUPIA may require it to report income generated by that entity. Section 175.401(a) defines an entity to mean 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 or a business that elects to maintain separate records pursuant to section 175.403.[401] A trust's obligation to report a portion of the income that an entity earns may not necessarily be accompanied by a cash distribution to the trust.[402] The OUPIA includes a specific provision to address this common situation.

Pursuant to section 175.505(C), the trustee must first determine the tax that the trust must pay on the taxable income that the entity must report.[403] The difficulties associated with computing the actual amount of tax attributable to income and principal receipts noted above apply equally to making this determination. The trustee then allocates that tax between income and principal based on the nature of the receipts the trust received from the entity.

Assume that the trust receives no distributions from the entity but must report a portion of the entity's income. Because the trust did not receive any receipts allocable to income, section 175.505(C)(1) allocates no portion of the

400. Because the statute is silent with respect to the details of the actual calculation, it would not appear to preclude this approach.

401. 60 OKLA. STAT. § 175.401(A) (2001). The definition of "entity" in section 175.401(A) is expressly limited to the allocation of receipts from entities between income and principal. *Id.* § 175.401(B). Section 175.505(C), however, references the allocation of receipts from entities, and the term should have the same definition for purposes of allocating the tax burden.

402. For example, a partner must report her share of partnership income regardless of whether the partnership makes any distributions to its partners. I.R.C. § 702 (2000). A beneficiary, however, generally must report a portion of an estate or trust's income only if that beneficiary receives a distribution. *See id.* §§ 652, 662. For that reason, the general principles outlined in sections 175.505(A), (B), and (D), rather than the special rule in section 175.505(C) relating to entities, control the allocation of the tax burden with respect to the trust's share of income from another trust or estate.

403. *See* 60 OKLA. STAT. § 175.505(C) (2001).

tax attributable to the trust's share of the entity's taxable income to income.[404] As a result, section 175.505(C)(2)(b) allocates all of the tax against principal.[405]

Assume that the trust receives distributions from an entity, all of which are allocated to income.[406] If the distributions exceed the entity's taxable income that the trust must report, the OUPIA charges against income all taxes attributable to the inclusion of the entity's income.[407] If the distributions are less than the entity's taxable income that the trust must report, the OUPIA allocates against income a proportionate amount of the taxes. A trustee can compute this amount by multiplying the amount of tax attributable to the entity by a fraction, the numerator of which equals the income receipts from the entity and the denominator of which equals the trust's share of the entity's taxable income.[408] The OUPIA allocates the balance of the tax to principal.[409] In other words, if a trust must report $10,000 of income as the result of its ownership interest in an entity, if the trust's tax attributable to the inclusion of that amount in its taxable income is $2000, and if the trust receives a $6000 distribution from the entity that is allocated to income, $1200 of the tax ($2000 times $6000 / $10,000) is allocated against income and $800 ($2000-$1200) is allocated against principal.

If the trustee allocates the receipts from the entity to both income and principal, the allocation of the tax on the trust's share of the entity's taxable income depends on whether the total receipts from the entity exceed the trust's share of the entity's taxable income.[410] If the total receipts exceed taxable income, the amount of the tax on the trust's share of the entity's taxable income allocated against income is equal to the tax times a fraction, the numerator of which equals the income receipts from the entity and the denominator of which equals the total income and principal receipts.[411] The OUPIA allocates the balance of the tax against principal.[412] Assume the same facts outlined above, except that the trust received $6000 of distributions from the entity allocated to income and $9000 allocated to principal. Because the total distributions ($15,000) exceed the trust's share of the entity's taxable

404. *See id.* § 175.505(C)(1).

405. *See id.* § 175.505(C)(2)(b).

406. For a discussion of the allocation of receipts from an entity, see title 60, sections 175.401 to 175.403 of the Oklahoma Statutes.

407. 60 OKLA. STAT. § 175.505(C)(1) (2001).

408. *Id.* § 175.505(C).

409. *Id.* § 175.505(C)(2)(b).

410. *Id.* § 175.505(C).

411. *Id.* § 175.505(C)(1), (2)(a).

412. *Id.* § 175.505(C)(2).

income ($10,000), the amount of the tax allocated to income is $800, which is the tax on the trust's share of the entity's taxable income ($2000) times a fraction, the numerator of which is the amount of the income receipts ($6000) and the denominator of which is the total receipts ($15,000). The OUPIA allocates the balance of the tax ($1200) against principal.

If the total income and principal receipts from the entity are less than the trust's share of the entity's taxable income, the amount of the tax allocated against income is equal to the tax times a fraction, the numerator of which is equal to the income receipts and the denominator of which is equal to the trust's share of the entity's taxable income.[413] The trustee must allocate the balance of the tax against principal.[414] Assume the same facts outlined above, except that the trust received $4000 of distributions from the entity allocated to income and $5000 allocated to principal. Because the total distributions ($9000) are less than the trust's share of the entity's taxable income ($10,000), the amount of the tax allocated to income is $800, which is the tax on the trust's share of the entity's taxable income ($2000) times a fraction, the numerator of which is the amount of the income receipts ($4000) and the denominator of which is the trust's share of the entity's taxable income ($10,000). The OUPIA allocates the balance of the tax ($1200) against principal.

(2) Tax-Driven Adjustment

An estate's executor may deduct administration expenses, such as executor fees, attorney fees, and casualty losses, on either the estate tax return or the income tax return, but not both.[415] In making this election, an executor normally compares the marginal tax rates.[416] In most cases, an executor realizes greater savings by claiming a deduction on the federal estate tax return.[417]

413. *Id.* § 175.505(C)(1), (C)(2)(b).

414. *Id.* § 175.505(C)(2)(b).

415. Section 642(g) of the Internal Revenue Code provides that deductions allowed for federal estate tax purposes under either §§ 2053 or 2054 of the Internal Revenue Code are not also allowed as a deduction for income tax purposes. In most instances, this refers to administration expenses that a trustee may claim for estate tax purposes as provided in § 2053(a)(2), and for income tax purposes as provided in § 212, and losses for thefts, fire, and other casualties that a trustee may claim for estate tax purposes as provided in § 2054, and for income tax purposes as provided in § 165.

416. There are other considerations, however. For example, if the expense is a miscellaneous itemized deduction, it is subject to a 2% floor for income tax purposes. *See* I.R.C. § 67(a), (e) (2000).

417. Assuming the decedent dies in 2002, the lowest marginal rate for estate tax purposes is 41%, *id.* § 2001(c), which is greater than the highest marginal rate for fiduciary income tax

For years, trustees and courts have struggled with a conflict that often arises between a trustee's duty of impartiality with respect to the beneficiaries and its duty to save income and estate taxes through postmortem tax planning.[418] The estate taxes are charged against principal, and income taxes are normally charged against income.[419] Thus, if a deduction that a trustee otherwise charges against principal is claimed on the estate tax return, the savings rightfully inures to the benefit of the principal account. If the trustee claims that same deduction on the estate's income tax return, however, the tax savings inures to the benefit of the income account. A similar problem arises when a trustee deducts an expense that is charged against the estate's net income on the estate tax return, reducing the federal estate tax and generating a benefit for the principal account.

In many jurisdictions, courts have required trustees to make equitable adjustments between principal and income, returning the value of the lost deduction to the principal (or income) account.[420] Before enacting the OUPIA, the Oklahoma legislature and courts failed to address the problem clearly. Section 175.506, however, provides for both discretionary and mandatory adjustments when the elections that the trustee makes shift economic benefits between income and remainder beneficiaries.

The express language of the governing instrument may override the trustee's duty to make an equitable adjustment.[421] Many wills and trust instruments contain a provision similar to the following:

> My executor shall make such elections and allocations under the tax laws as my executor deems advisable, without regard to the relative interests of the beneficiaries and without liability to any person. No adjustment shall be made between principal and income or in the relative interests of the beneficiaries to compensate for the effect of elections or allocations under the tax laws made by my executor.

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purposes, which is 39.6%, *id.* § 1(e). For a full discussion of the planning considerations, see PRICE, *supra* note 189, § 12.13.

418. There is a long-standing, historical acknowledgment of a trustee's duty of impartiality. Courts have more recently recognized the duty to minimize taxes. For an excellent discussion of this and other issues relating to equitable adjustments, see Joel C. Dobris, *Equitable Adjustments in Postmortem Income Tax Planning: An Unremitting Diet of* Warms, 65 IOWA L. REV. 103 (1979).

419. *See* 60 OKLA. STAT. §§ 175.502(A)(6), 175.505 (2001).

420. *See, e.g.*, Estate of Bixby, 295 P.2d 68 (Cal. Dist. Ct. App. 1956); Estate of Warms, 140 N.Y.S.2d 169 (Sur. Ct. 1955).

421. For a general discussion with respect to overriding the application of the OUPIA. *See supra* Part II.A.

Such clauses clearly override the application of section 175.506. Drafters generally include them in wills and trusts to promote efficiency and to ease the burden of administration. An attorney should give considerable thought, however, before automatically including a remission clause in an instrument's boilerplate.[422]

(a) Mandatory Adjustments

Depending on the terms of the marital or charitable gift, the amount of the gift may depend on whether the trustee claims a deduction for estate or income tax purposes. Section 175.506(B) provides a mandatory adjustment from income to principal where the payment of additional estate taxes reduces a marital or charitable deduction because of the trustee's election to claim a deduction for income tax purposes.[423] This adjustment reimburses principal for the amount of the increased estate tax, permitting the spouse or charity to receive the same amount they would have received had the trustee claimed the deduction on the estate tax return.

Each estate, trust, or beneficiary who benefits from the decrease in income tax must contribute its proportionate share of the total income tax savings.[424] Claiming the deduction on the estate's income tax return reduces the estate's adjusted gross income and distributable net income. If the estate does not make any distributions, the estate will realize the income tax savings. If the estate distributes the distributable net income to its beneficiaries, the beneficiaries will realize the savings.

The primary purpose of the adjustment is to restore the marital or charitable deduction for estate tax purposes.[425] To comprehend fully the application of section 175.506(B), it is important first to understand the interrelationship of the marital and charitable deductions and taxes and administration expenses. For purposes of this discussion, it is assumed that a gift is made to a surviving spouse that qualifies for the federal estate tax marital deduction pursuant to § 2056. The same principles apply, however, with respect to transfers that qualify for the charitable deduction pursuant to § 2055.

Generally, taxes and other administrative expenses payable from the marital bequest reduce the marital deduction.[426] If estate taxes are payable from the

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422. For a thoughtful discussion of the effect of remission clauses, see Joel C. Dobris, *Limits on the Doctrine of Equitable Adjustment in Sophisticated Postmortem Tax Planning*, 66 IOWA L. REV. 273 (1981).

423. 60 OKLA. STAT. § 175.506(B) (2001); *see* UNIF. PRINCIPAL & INCOME ACT § 506 cmt. (amended 1997), 7B U.L.A. 189 (2000).

424. 60 OKLA. STAT. § 175.506(B) (2001).

425. *See, e.g.*, Estate of Britenstool v. Commissioner, 46 T.C. 711 (1966).

426. I.R.C. § 2056(b)(4) (2000); Treas. Reg. § 20.2056(b)-4(c), (d) (as amended in 1999).

marital share, the marital deduction is reduced and the taxes are therefore increased, resulting in an interrelated computation. Indeed, the nature of this computation can surprisingly increase the amount of tax and reduce the amount of the marital bequest. Assume, for example, that a decedent died in 2001 with a gross estate of $4,000,000. Under her will, she provided that $2,000,000 pass to her surviving spouse and $2,000,000 pass to her children. If the state imposes a tax equal to the federal credit for state death taxes and if all taxes are payable from the children's share, the total tax obligation is $560,250 (comprising $460,650 of federal estate tax and $99,600 of state death tax), and the spouse receives $2,000,000. If, however, the taxes are payable from the marital share, the tax burden more than doubles to $1,156,111 (comprising $959,924 of federal estate tax and $196,187 of state death tax), which reduces the spouse's share to $843,889.

The same problem exists with respect to the payment of administration expenses. Assume the same facts as in the preceding example, except that both administrative expenses and estate taxes are payable from the marital share. Also assume that the estate pays $50,000 of executor fees, which the trustee charges against principal.[427] As a result, the spouse receives $1,950,000 prior to the payment of estates taxes. If the estate deducts those fees on its estate tax return, the total estate tax obligation remains at $1,156,111. However, if the executor claims the deduction on the income tax return, the estate tax obligation increases by $61,111 (the federal estate tax increases to $1,010,369 and the state death tax becomes $206,853).[428]

Because section 175.506(B) only applies when the marital or charitable deduction is reduced (and the estate taxes are correspondingly increased) by the payment of expenses from principal that are deducted on the estate's income tax return, it is also necessary to understand whether the payment of an administration expense reduces the amount passing to the surviving spouse or charity.[429] In 1997, the U.S. Supreme Court determined that under the existing regulations, administration expenses properly charged against income

427. Under section 175.201(2)(b), the executor has discretion to charge executor fees against income or principal.

428. Obviously no executor would knowingly elect to deduct the fees on the estate's income tax return in this situation because the income tax savings would be significantly less. In fact, the drafters concluded that an executor will elect to deduct administration expenses on the income tax return only when the income tax reduction exceeds the estate tax reduction. *See* UNIF. PRINCIPAL & INCOME ACT § 506 cmt. (amended 1997), 7B U.L.A. 189 (2000).

429. Estate taxes are not deductible for either federal estate tax purposes, I.R.C. § 2053(c)(1)(B) (2000), or income tax purposes, *id.* § 164(a). As a result, the adjustment provided for in section 175.506(B) only applies to administration expenses and other amounts properly deductible on both the estate and income tax return, but not both. *See* I.R.C. §§ 212, 642(g), 2053 (2000).

should not affect the amount of the marital deduction unless the anticipated expenses are material in relation to the anticipated marital share income.[430] The regulations have recently been amended to provide more certainty in the area.[431]

To determine the effect of the payment of an administration expense on the marital or charitable deduction, the expense must first be categorized as either a management or transmission expense.[432] Management expenses are expenses that an estate incurs in connection with the investment of estate assets or with their preservation or maintenance during a reasonable period of administration, such as investment advisory fees, stock brokerage commissions, custodial fees, and interest.[433]

Estate transmission expenses are expenses that an estate would not have incurred but for the decedent's death and the necessity of collecting the decedent's assets, paying the decedent's debts and death taxes, and distributing the decedent's property to those who are entitled to receive it.[434] "[T]ransmission expenses include any administration expense that is not a management expense."[435] Thus, executor commissions and attorney fees (other than those incurred to invest, preserve, or maintain assets), probate fees, expenses incurred in construing or defending a will, and appraisal fees are transmission expenses.[436]

The marital deduction is not reduced by the amount of estate management expenses attributable to and paid from the marital share.[437] The marital deduction, however, is reduced by the amount of estate transmission expenses paid from the marital share[438] and by the amount of estate management expenses paid from the marital share but attributable to property not included in the marital share.[439] This reduction occurs regardless of whether the estate

430. Commissioner v. Estate of Hubert, 520 U.S. 93 (1997) (plurality opinion).

431. Treas. Reg. § 20.2056(b)-4(d) (as amended in 1999).

432. *See id.* § 20.2056(b)-4(d)(2) to (4).

433. *Id.* § 20.2056(b)-4(d)(1)(i).

434. *Id.* § 20.2056(b)-4(d)(2)(ii).

435. *Id.*

436. *Id.*

437. *Id.* § 20.2056(b)-4(d)(3). If the estate claims a deduction for these expenses on the estate tax return, § 2056(b)(9) of the Internal Revenue Code requires that the estate reduce the marital deduction by the amount claimed as a deduction under § 2053. Because deductions claimed on the estate tax return do not give rise to income tax savings, however, an adjustment from income to principal under section 175.506(B) is not warranted.

438. Treas. Reg. § 20.2056(b)-4(d)(2) (as amended in 1999).

439. *Id.* § 20.2056(b)-4(d)(4).

claims the deduction for those expenses on the estate or income tax return.[440]

Thus, there are two separate issues when determining the effect of the payment of administration expenses on the amount that passes to the surviving spouse. The first involves whether the payment of the expense reduces the marital deduction regardless of whether the estate claims the deduction for the expense on the estate or income tax return. Federal regulations control this determination. The second involves when the OUPIA requires a mandatory adjustment between income and principal as a result of claiming the deduction on the estate's income tax return.

The interaction of section 175.506(B) and the regulations under § 2056 are best illustrated through simple examples, which again assume that the estate claims a marital deduction. The examples also only address federal estate tax consequences. The same problem exists in the event Oklahoma estate taxes are increased as the result of the estate claiming a deduction on the income tax return rather than the estate tax return.

Assume that the decedent made gifts of specific property to family members and directed that the residue of her estate pass to her surviving spouse, and therefore qualifies for the marital deduction. Under the terms of the will, all administration expenses are payable from the marital share. The estate incurs $50,000 in executor fees. Prior to the payment of this expense, the residue consisted of property worth $1,000,000 based on its value as of the decedent's date of death.[441] Also, during the year in which the estate paid the executor fee, it had $70,000 of adjusted taxable income before taking into account any deduction for executor fees. The OUPIA grants the executor discretion to charge executor fees against principal or income.[442]

If the executor fees are estate transmission fees under the federal regulations,[443] the marital deduction under § 2056 must be reduced by the full amount of the fees, regardless of whether the estate claims them as a deduction on the estate tax or income tax return.[444] If the estate deducts the fees on the estate tax return, the reduction in the marital deduction is offset by the deduction of the fees under § 2053, and the taxable estate for federal estate

440. *See id.* § 20.2056(b)-4(d)(5), example 1. This should be the case because the estate has expended these amounts and the spouse will therefore not receive them.

441. The marital deduction is based on the value of the qualifying asset used for estate tax purposes. *See* I.R.C. § 2056(a) (2000); Treas. Reg. § 20.2056(b)-4(a) (as amended in 1999). Generally, this means the date-of-death value unless the alternate valuation method is elected under § 2032 of the Internal Revenue Code.

442. *See* 60 OKLA. STAT. § 175.201(2)(b) (2001).

443. This assumes that the fees are not "related to the investment, preservation, or maintenance of the estate's assets." *See* Treas. Reg. § 20.2056(b)-4(d)(1)(ii) (as amended in 1999).

444. *Id.* § 20.2056(b)-4(d)(2).

tax purposes remains unchanged. In this case, there is no adjustment under section 175.506(B) between income and principal because the estate did not deduct the fees on the estate's income tax return. If the estate deducts the fees on the income tax return, however, the marital deduction for estate tax purposes still must be reduced to $950,000, and the estate does not receive an offsetting deduction under § 2053. Assume that as the result of this election, the estate incurs $20,000 of additional estate tax and realizes $30,000 in income tax savings.[445] Section 175.506(B) requires the estate (or its beneficiaries) to reimburse principal for $20,000, which represents the increase in estate tax resulting from the failure to claim the deduction on the estate tax return. The spouse receives the same amount she would have received had the estate claimed the deduction on the estate tax return. Thus, the estate is entitled to a $1,000,000 marital deduction.[446] Based on a cursory analysis, one might conclude that the estate should receive a $970,000 marital deduction and that allowing a greater deduction conflicts with the federal regulations.[447] The spouse receives from the estate, however, the same amount she would have received had the estate been entitled to a $1,000,000 marital deduction, and, in accordance with the reasoning in *Estate of Britenstool v. Commissioner*,[448] the estate may deduct the greater amount.[449]

Assume the same facts as above, but that the gifts to the decedent's family members were less than the available unified credit amount so that no estate taxes are payable from the estate.[450] In this case, the executor would normally elect to deduct the executor fees on the estate's income tax return because the estate would receive no tax benefit if it claimed the deduction on its estate tax return. Federal law still requires the estate to reduce the marital deduction for estate tax purposes by the amount of executor fees.[451] Because the estate can

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445. The estate will enjoy this savings if it makes no distributions during the year in question. I.R.C. § 661 (2000). If the estate distributes its distributable net income, the tax savings will inure to the benefit of the estate's beneficiaries. *Id.* §§ 661, 662.

446. *See* Estate of Britenstool v. Commissioner, 46 T.C. 711 (1966). For this example, in a somewhat simpler scenario, see UNIF. PRINCIPAL & INCOME ACT § 506 cmt. (amended 1997), 7B U.L.A. 189 (2000).

447. This inconsistency could be avoided if the Internal Revenue Code allowed the additional deduction as an administration expense under § 2053(a)(2) of the Internal Revenue Code. There is no support for this approach, however, which itself conflicts with § 642(g) of the Internal Revenue Code.

448. 46 T.C. 711 (1966); *see also* Dobris, *supra* note 422.

449. It could not have been the intent of the drafters of Treasury Regulation § 20.2056(b)-4(d) to overrule the application of *Britenstool.*

450. For decedents dying in 2002 and 2003, that amount is $1,000,000, and for those decedents dying in 2004 and 2005, that amount is $1,500,000. I.R.C. § 2010(c) (2000).

451. Treas. Reg. § 20.2056(b)-4(d)(2) (as amended in 1999). This is true even if the executor is not required to file a federal estate tax return.

obtain an income tax benefit without causing an increase in the estate tax, the executor is not diverting a tax benefit that would otherwise inure to the benefit of the principal account. Therefore, this action does not violate the trustee's duty of impartiality. Correspondingly, section 175.506(B) does not mandate an adjustment from income to principal.[452]

Assume the same set of facts, but that the will contains a formula bequest to the surviving spouse that provides that the spouse receives the smallest amount required to eliminate the federal estate tax. Because of the formula clause, there will be no federal estate tax regardless of where the executors claim the deduction. If the estate claims the $50,000 deduction on the federal estate tax return, $50,000 less marital deduction is required to achieve the optimum tax result, and $50,000 more can pass to the by-pass trust.[453] If, however, the estate claims the deduction on its income tax return, an additional $50,000 marital deduction is required to eliminate the federal estate tax, and $50,000 less will pass to the by-pass trust. Thus, the net effect of deducting the expenses on the income tax return is to pay those expenses out of the by-pass trust. In this case, there is at least some advantage to deducting the expenses on the estate tax return.[454] Because the executor will not pay estate taxes in either case, however, it cannot make a mandatory adjustment pursuant to section 175.506(B).[455]

Assume the original set of facts, but that the executor properly exercises its discretion to charge the executor fee against the estate's income.[456] Equitable adjustments are based on the theory that the tax deduction arising from expenses that are charged against principal for accounting purposes should benefit the principal account.[457] In this case, the OUPIA charges executor fees against income. The deduction of those fees on the estate's income tax return benefits the income beneficiaries, and no adjustment is warranted. Because the mandatory adjustment provision in section 175.506(B) applies only if the trustee charges an expense against principal, the statute dictates the same result.[458]

452. For an adjustment to be made, the marital deduction must be reduced, and "as a result estate taxes paid from principal are increased." 60 OKLA. STAT. § 175.506(B) (2001).

453. *See* PRICE, *supra* note 189, § 5.34.2.

454. By deducting the expenses on the estate tax return, the estate can increase the amount that transferred to the by-pass trust, which will avoid taxation in the surviving spouse's estate.

455. Nor does this seem like an appropriate situation to make a discretionary adjustment pursuant to section 175.506(A).

456. *See* 60 OKLA. STAT. § 175.201(2)(b) (2001).

457. Dobris, *supra* note 418.

458. A different issue arises if the estate deducts the expense charged against income on the estate tax return, benefitting the principal account. Although section 175.506(B) would not apply because the estate charged the expense against income, this might be an appropriate

Finally, assume that the trustee charged the fees against principal for accounting purposes but that the fees were estate management expenses attributable to the marital share rather than transmission expenses.[459] The payment of estate management expenses does not decrease the marital deduction for federal estate tax purposes even though the executor pays those fees from the marital share.[460] Thus, there is no resulting increase in the amount of the federal estate tax, and there is no mandatory adjustment under section 175.506(B).[461]

If the fees are management expenses that are not attributable to the marital share, the marital deduction is reduced by the amount of the fees paid from the marital share.[462] In that case, deducting the fees on the income tax return will result in the payment of additional estate tax, and the executor must make a mandatory adjustment between income and principal equal to the amount of the additional estate tax resulting from the executor's election.

Consider the results if the mandatory adjustment provision applies and if the executor elects to claim a deduction on the income tax return even though the income tax savings are less than the savings that would have resulted had the executor claimed the deduction on the estate tax return. For obvious reasons, the OUPIA comments indicate that such a result should not occur.[463] The statute provides that the adjustment between income and principal should equal the amount of the increase in the federal estate.[464] This, however, exceeds the amount of income tax savings. The equitable result would be to limit the adjustment from income to principal to the lesser of the income tax savings and the estate tax cost.[465]

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situation for the executor to make a discretionary adjustment from principal to income pursuant to section 175.506(A).

459. For the definition of these terms, see Treas. Reg. § 20.2056(b)-4(d)(1) (as amended in 1999); *supra* notes 432-36 and accompanying text.

460. Treas. Reg. § 20.2056(b)-4(d)(3) (as amended in 1999).

461. This also presents less compelling circumstances to make a discretionary adjustment under section 175.506(A).

462. Treas. Reg. § 20.2056(b)-4(d)(4) (as amended in 1999). This assumes that the executor still charges the fees against principal for accounting purposes.

463. *See* UNIF. PRINCIPAL & INCOME ACT § 506 cmt. (amended 1997), 7B U.L.A. 189 (2000).

464. 60 OKLA. STAT. § 175.506(B) (2001).

465. An alternative, of course, would be to reimburse principal for the full amount of the additional estate tax and to advise the income beneficiaries to seek the difference from the executor or its insurance carrier.

(b) Discretionary Adjustments

Section 175.506(A) permits the trustee to make discretionary adjustments between income and principal to offset the shifting of economic interests that might arise in three separate situations.

The first situation relates to elections and decisions that the trustee makes when faced with more than one alternative with respect to a tax election.[466] For example, a trustee may have the option of deducting an expense on either the estate or income tax return. If the trustee elects to deduct administration expenses that it charges against principal on the income tax return, economic benefit shifts between the principal beneficiaries and the income beneficiaries.[467] Even in those cases where section 175.405(B) does not mandate an adjustment, the trustee has discretion to make an adjustment pursuant to section 175.405(A).[468]

An adjustment may also be warranted where economic benefits shift due to a tax imposed on the trustee or a beneficiary as the result of a transaction or distribution affecting the estate or trust.[469] For example, a distribution from an estate to a beneficiary will normally carry with it distributable net income.[470] To the extent that the estate makes the distribution to a beneficiary who is otherwise entitled to receive income that the estate generates during administration, there is no shifting of economic benefit, and no adjustment is warranted. An adjustment may be appropriate, however, if the estate distributes a principal asset that causes taxable income to be carried out to the distributee and relieves the estate and beneficiary entitled to the estate's income of any obligation to pay tax on that income.

Because an estate's income generally inures to the benefit of the residuary beneficiaries, a distribution to a residuary beneficiary will generally not warrant an adjustment because the same beneficiary who ultimately receives the income reports that income. If an estate has more than one residuary beneficiary and during the year makes disproportionate distributions to those beneficiaries, however, the beneficiaries must report a disproportionate amount of the estate's income, in which case the trustee may consider an adjustment.[471]

An estate may also be required to recognize capital gain as the result of a distribution. For example, assume that the testator made a specific gift of

466. *See* 60 OKLA. STAT. § 175.506(A)(1) (2001).
467. For a full discussion of equitable adjustments, see Dobris, *supra* note 418.
468. *See supra* Part III.B.2.c.(2).(a).
469. 60 OKLA. STAT. § 175.506(A)(2) (2001).
470. *See* I.R.C. §§ 661, 662 (2000).
471. *Id.* § 662.

$10,000 to a beneficiary, and, during administration, the beneficiary agreed to accept an asset that was worth $10,000 at the time of distribution. If the estate's basis in the asset is less than $10,000, the estate recognizes gain on the distribution,[472] and generally will pay the resulting tax obligation.[473] This gain inures to the benefit of the estate's principal,[474] and the resulting tax is charged against principal.[475] Because there is no shifting of economic interests, an adjustment is inappropriate. An estate may also elect to recognize gain with respect to all distributions made during a tax year.[476] In this case, it is more likely that the recognition of gain will be accompanied by the shifting of economic interests, and the trustee should be alert to the desirability of making equitable adjustments.

Finally, a trustee has discretion to make an equitable adjustment in situations where the trust or estate owns an interest in an entity whose taxable income is included in the taxable income of the estate, trust, or beneficiary.[477] The tax that the trust is required to pay on the entity's income that the trust is required to report is generally charged against income to the extent that receipts are allocated to income and against principal to the extent the receipts are allocated to principal.[478] Because the entity may not make cash distributions to the trust, the payment of the tax can benefit the principal account at the expense of the income account. This is best illustrated by an example in the comments:

> Section 506(a)(3) applies to a qualified Subchapter S trust (QSST) whose income beneficiary is required to include a pro rata share of the S corporation's taxable income in his return. If the QSST does not receive a cash distribution from the corporation that is large enough to cover the income beneficiary's tax liability, the trustee may distribute additional cash from principal to the income beneficiary. In this case the retention of cash by the corporation benefits the trust principal. This situation could occur if the

472. *See* Kenan v. Commissioner, 114 F.2d 217, 220 (2d Cir. 1940). If the estate's basis is greater than $10,000, it may also recognize the loss. *See* I.R.C. § 267(b)(13) (2000).

473. Except in an estate's final year, capital gains are generally not included in the estate's distributable net income and thus not distributed. *See* I.R.C. § 643(a)(3) (2000).

474. The estate satisfied a $10,000 obligation by distributing an asset worth $10,000. This is analogous to the estate selling the asset and distributing cash, in which case the estate would have allocated to principal the gain recognized on the sale. *See* 60 OKLA. STAT. § 175.404(2) (2001).

475. *Id.* § 175.505(B).

476. I.R.C. § 643(e)(3) (2000).

477. 60 OKLA. STAT. § 175.506(3) (2001).

478. *See id.* § 175.505(C).

> corporation's taxable income includes capital gain from the sale of a business asset and the sale proceeds are reinvested in the business instead of being distributed to shareholders.[479]

The same principles apply to partnerships. The problem is not as common with respect to other trusts and estates because a distribution accompanies the resulting tax obligation.

Section 175.506(A) grants the trustee discretion to make equitable adjustments in those situations outlined above, but does not mandate its exercise. In fact, the statute and the comments provide little guidance as to when the trustee should exercise its discretion, and extensive case law does not exist either in Oklahoma or in the other adopting states.

Perhaps earlier cases in other jurisdictions that have addressed these issues should guide the trustee.[480] In determining whether to make an equitable adjustment, courts examine several considerations, including:

> any presumed preference for the beneficiary diminished or enhanced; the apparent tax consciousness of the testator; the magnitude of the imposition on the diminished beneficiary; the clarity of the beneficiary's injury; the extent to which core property interests of the beneficiary have been disturbed; the perception of the action as being fair and reasonable; fiduciary and judicial efficiency of administration in both formulating and applying the adjustment; the proximity of the imposition to the administration of the estate; the fiduciary's role, if any, in setting in motion the events which led to the perceived imposition; whether the action was one taken to aid a particular beneficiary or was a neutral event in the administration of the estate; the extent to which the action complained of generated extra money and the extent to which it was generated at a cost to a beneficiary; and, finally, the finite supply of time and energy to administer estates and the finite capacity to absorb complexity in estate administration.[481]

The settlor may establish a trust making a completed gift for gift tax purposes but intentionally reserve sufficient interests so that the trust's income is taxable to the settlor pursuant to the grantor trust rules.[482] By establishing

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479. *See* UNIF. PRINCIPAL & INCOME ACT § 506 cmt. (amended 1997), 7B U.L.A. 189 (2000).

480. For an excellent overview of this area and a discussion of the various issues, see generally Dobris, *supra* note 422.

481. *Id.* at 340.

482. *See* I.R.C. §§ 671-679 (2000).

an intentionally defective grantor trust, the settlor can increase the value of the property transferred to the trust's beneficiaries without paying additional gift tax because tax law does not treat payment of the tax on the trust's income as an additional gift from the settlor.[483] This planning technique necessarily involves the shifting of economic interests from the settlor to the trust's beneficiaries. The trustee's reimbursement of the settlor for the payment of the taxes would defeat one of the primary purposes for which the settlor established the intentionally defective grantor trust. There are other trusts that are unintentionally subject to the grantor trust rules, in which case it might be desirable to distribute either trust income or principal to the settlor to permit the settlor to pay her resulting tax obligation. The OUPIA does not authorize the trustee to distribute funds to the settlor in either of these cases because the drafters considered it too difficult to establish a rule that would apply only to those trusts in which the grantor trust status was an unintended result.[484]

3. The Trustee's Power to Adjust

The OUPIA's cornerstone is the fiduciary's power to make adjustments between income and principal pursuant to section 175.104. The Oklahoma Uniform Prudent Investor Act,[485] enacted by the Oklahoma legislature in 1995,[486] discarded the historical view that courts should evaluate investments on an individual basis. Rather, courts now apply the standard of prudence to all of the trust's investments viewed as a portfolio.[487] The Act permits trustees to invest for higher total yields, not necessarily limited to income derived from interest, dividends, rents, and other forms of traditional trust income.[488] Adopting the portfolio approach for trust investments liberalized the rules with respect to trusts that may accumulate income. If the trust instrument required the trustee to distribute income, however, the enactment of the Uniform Prudent Investor Act did not significantly change the trustees' historic investment authority. The trustee was required to continue to make investment decisions based, in large part, on its obligation to earn sufficient income defined in traditional terms for distribution to the beneficiary to fulfill its duty of impartiality.

483. For a discussion of the planning possibilities, see KATHRYN G. HENKEL, ESTATE PLANNING AND WEALTH PRESERVATION ¶ 6.06 (1997).

484. *See* UNIF. PRINCIPAL & INCOME ACT § 506 cmt. (amended 1997), 7B U.L.A. 189-90 (2000). In appropriate circumstances, the trust instrument could require the trustee to reimburse the settlor (or other grantor) for taxes paid on the trust's income. *Id.*

485. 60 OKLA. STAT. §§ 175.60-175.72 (2001).

486. Oklahoma Uniform Prudent Investor Act, ch. 351, 1995 Okla. Sess. Laws 1841.

487. *See* 60 OKLA. STAT. § 175.62(B) (2001).

488. *See id.* § 175.62(C).

The OUPIA contains two provisions that effectively extend the portfolio investment approach to mandatory income distribution trusts. First, the OUPIA abolishes the unproductive and underprodutive property rule. Second, and perhaps more important, the OUPIA grants the fiduciary power to adjust between income and principal if the administration of the trust is not fair and reasonable to all of the beneficiaries and if the trustee satisfies the other conditions in section 175.104.

For example, the OUPIA allows a trustee to invest in assets that yield little income but which have the potential for capital appreciation. By contrast, the historical approach treated any increase in the value of the trust assets as principal, which was not distributable to the income beneficiary. Even if a trust sold an appreciated asset, the gain was generally allocated to principal and was not distributed to the income beneficiary.[489] Under the OUPIA, the trustee may annually allocate a portion of the principal to income to the extent the trustee considers it necessary to increase the amount of distributable income.[490] In other situations, the trustee may deem it necessary to allocate a portion of the trust's income to principal. For example, in a period of high inflation, the trustee may invest in bonds that yield a high return. In consideration of the erosion of principal value due to inflation and other factors, the trustee may decide to transfer annually a portion of the income that the bonds generate to principal.[491]

The power to adjust does not authorize a trustee to increase or decrease a beneficiary's enjoyment of the trust property. It only authorizes the trustee to adjust between income and principal to the extent that the trust's income otherwise determined is too small or too large as a result of the trustee's investment decisions. The goal is to ensure that the trust's administration is fair to all beneficiaries.

The power to adjust is particularly important to trusts that were irrevocable on November 1, 1995, the effective date of the Oklahoma Uniform Prudent Investor Act. Although the Act controls decisions and actions taken after its effective date,[492] for preexisting trusts the trustee may select investments using the prudent person standard without regard to its effect on the amount of trust accounting income. The trustee may then make adjustments under section 175.104 to maintain the beneficiaries' respective interests in the trust.

489. Prior to November 1, 1998, when a fiduciary sold unproductive property, it was required to allocate the sales proceeds between income and principal. *See* 60 OKLA. STAT. § 175.35 (1991).

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

491. *Id.* § 104 cmt., example (2), 7B U.L.A. at 147.

492. 60 OKLA. STAT. § 175.71 (2000).

A trustee is granted discretion to make adjustments between income and principal only if several prerequisites are satisfied. Based on the relevant factors, the trustee must then determine whether and to what extent an adjustment should be made.

a) Prerequisites to Grant of Discretion

The trustee must satisfy many conditions before it may make an adjustment. First, section 175.104(A) requires that the trustee manage the trust assets as a prudent investor. In Oklahoma, that means that the trustee must comply with the Oklahoma Uniform Prudent Investor Act.[493] The Prudent Investor Act generally applies to all trusts created on or after November 1, 1995, and to all decisions and actions occurring after that date with respect to those trusts created before that date.[494]

The terms of the trust instrument may exempt the trustee from complying with the Uniform Prudent Investor Act.[495] More precisely, the trust instrument itself must invoke the application of the Act.[496] The following or comparable language, unless otherwise limited or modified by the trust instrument, authorizes any investment strategy permitted under the Uniform Prudent Investor Act:

> "Investments permissible by law for investment of trust funds", "legal investments", "authorized investments", "using the judgment and care under the circumstances then prevailing that persons of prudence, discretion, and intelligence exercise in the management of their own affairs, not in regard to speculation but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of their capital", "prudent man rule", "prudent trustee rule", "prudent person rule", and "prudent investor rule".[497]

Given that the Oklahoma legislature intended the Uniform Prudent Investor Act to apply to investment decisions made after its effective date, and because

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493. The trustee may also satisfy this condition in states that have not enacted the Uniform Prudent Investor Act if they have passed other prudent investor legislation, if the courts have approved the prudent investor rule, or if the trust instrument requires it. UNIF. PRINCIPAL & INCOME ACT § 104 cmt. (amended 1997), 7B U.L.A. 144 (2000).

494. 60 OKLA. STAT. § 175.71 (2001).

495. *Id.* § 175.61(B).

496. Although there is a presumption that the Uniform Prudent Investor Act applies, the ease with which courts have held that the settlor intended to override it leads to the speculation that it must be directly invoked. *See, e.g.*, Atwood v. Atwood, 2001 OK CIV APP 48, ¶¶ 22, 29, 25 P.3d 936, 943-44.

497. 60 OKLA. STAT. § 175.70 (2001).

most trust instruments contain language comparable to the foregoing, it is likely that the first condition is satisfied.

Because there is no need to adjust between income and principal in the event that a trust does *not* link distributions to its income,[498] the second prerequisite is that the trust instrument describe the amount that it must or may distribute by referencing the trust's income.[499] The condition is satisfied when a named beneficiary receives all of the trust's income for a specific period of time, regardless of whether the trust subsequently distributes the principal to that person or to a different person. It is also satisfied if: (1) The trustee is required to distribute all of the income but has discretion to select the recipients; (2) A beneficiary is entitled to receive the greater of the trust's income and a fixed dollar amount; and (3) A beneficiary is entitled to receive the greater of the trust's income and a fractional share of the value of the trust assets.[500]

This condition will also be met if the trustee has discretion to distribute or accumulate the trust's income because the terms of the trust do not permit the trustee to distribute more than the income.[501] If the trustee has the power to distribute income and principal to a beneficiary, however, the trustee does not have the power to adjust because the understatement or overstatement of the trust's income does not adversely affect the trust's beneficiaries.

The third prerequisite is linked to the trustee's duty of impartiality. In other words, the trustee must administer the trust in accordance with the terms of the trust instrument and the OUPIA. If the trustee then concludes that it cannot administer the trust impartially, the third prerequisite is satisfied.[502]

If the trust expressly authorizes the trustee to favor one beneficiary at the expense of another, the trustee must determine the scope of that discretion.[503] If the trust instrument only partly negates the duty of impartiality, the third prerequisite is satisfied if the trustee determines that it is unable to achieve the level of partiality that the trust instrument permits or requires.[504]

The fourth prerequisite to the exercise of the power relates to the trust instrument. The trustee does not have the power to adjust if the settlor

498. For example, a trustee need not adjust between income and principal to preserve a trust's impartial administration to the extent that income is accumulated for ten years, at which time the trustee distributes principal and accumulated income to a named beneficiary.

499. 60 OKLA. STAT. § 175.104(A) (2001).

500. UNIF. PRINCIPAL & INCOME ACT § 104 cmt. (amended 1997), 7B U.L.A. 144 (2000).

501. *Id.*

502. *See* 60 OKLA. STAT. §§ 175.103, 175.104 (2001).

503. *See id.* § 175.103(A)(1), (2).

504. UNIF. PRINCIPAL & INCOME ACT § 104 cmt. (amended 1997), 7B U.L.A. 144 (2000).

intended to deny the trustee that power.[505] The statute makes clear, however, that the trust instrument overrides the power to adjust only if it is clear that the terms of the trust reflect the settlor's intent to deny it.[506] Although this does not require that the trust instrument specifically reference the statutory provision, generic statements relating to equitable adjustments will not suffice. Thus, a court should not construe a trust executed before the enactment of the OUPIA that prohibits the invasion of principal for an income beneficiary, or that prohibits equitable adjustments in general, as limiting the trustee's power to adjust.[507] For trusts executed after the OUPIA's effective date, it is advisable that the settlor specifically refer to the power to adjust under the OUPIA if the settlor intends to forbid its use.[508]

Finally, the statute outlines specific instances in which the trustee may not adjust even though the other requirements are satisfied.[509] The purpose of section 175.104(C) is to preserve the trust's intended tax consequences. Although that provision is generally self-explanatory, some sections deserve exploration.

The decedent's estate may be entitled to a marital deduction with respect to a trust in which the surviving spouse has a terminable interest[510] if (1) the trust qualifies as a general power of appointment trust pursuant to § 2056(b)(5) of the Internal Revenue Code or (2) the estate elects to claim a marital deduction for a trust that is qualified terminable interest property (QTIP) within the meaning of § 2056(b)(7). Both provisions require that the spouse receive all of the trust income for her life.[511] Section 175.104(C)(1) prohibits the trustee from making an adjustment that would diminish the income interest and thus jeopardize the marital deduction. The statute, however, does not preclude the trustee from increasing the income interest by

505. 60 OKLA. STAT. § 175.104(F) (2001).

506. *See id.*

507. UNIF. PRINCIPAL & INCOME ACT § 104 cmt. (amended 1997), 7B U.L.A. 146 (2000).

508. *Id.*

509. *See* 60 OKLA. STAT. § 175.104(C) (2001); *see also* UNIF. PRINCIPAL & INCOME ACT § 104 cmt. (amended 1997), 7B U.L.A. 144 (2000).

510. A terminable interest is an interest that passes from the decedent to the surviving spouse that will terminate or fail on the occurrence of an event or contingency or on the failure of an event or contingency to occur, but only if an interest in the property passes from the decedent to any person other than the spouse who will enjoy the property after the spouse's interest terminates. *See* I.R.C. § 2056(b)(1) (2000).

511. *See id.* §§ 2056(b)(5), 2056(b)(7)(B)(i)(II).

making an adjustment from principal to income.[512]

Note that the limitation only applies to QTIP trusts for which the executor has elected to claim a marital deduction on the estate tax return.[513] Care must be taken with respect to a QTIP trust for which a partial election has been made. Pursuant to the regulations, the executor may elect to treat a fractional interest in a single trust as qualifying for the marital deduction.[514] In this case, it is possible that an adjustment with respect to that portion of the trust for which the election was not made may affect the income interest in the portion that qualified for the marital deduction. If the adjustment would threaten the marital deduction, section 175.104(C)(1) would limit the trustee's discretion.

An estate trust is a trust that provides for either discretionary or mandatory distributions of income to the surviving spouse for life, with the residue payable to her estate on death. An estate trust is not a terminable interest because no interest passed from the decedent to a third person; thus, it qualifies for the marital deduction.[515] Because there is no requirement that the spouse receive all of the trust income during her life, the trustee's power to make an adjustment does not threaten the marital deduction. As a result, the limitation with respect to the power to adjust contained in section 175.104(C)(1) does not apply to estate trusts.[516]

A mandatory income interest in a trust qualifies as a present interest in property for purposes of the gift tax annual exclusion.[517] Thus, if income were payable to a beneficiary for five years, at which time the trust terminated, the actuarial value of the five-year income interest would qualify for the annual exclusion.[518] Section 175.104(C)(2) prohibits the trustee from reducing "the actuarial value of the income interest" if the settlor intended that interest to qualify for the annual exclusion. Again, this prohibition should not extend to

512. UNIF. PRINCIPAL & INCOME ACT § 104 cmt. (amended 1997), 7B U.L.A. 146 (2000). This is also consistent with the fact that principal distributions may be made to the surviving spouse from trusts that qualify for the marital deduction pursuant to either §§ 2056(b)(5) or (7) of the Internal Revenue Code.

513. *See* I.R.C. § 2056(7)(B)(v) (2000). If the executor fails to make the QTIP election, the trust does not qualify for the marital deduction. Prior to the recent change in § 20.2056(b)-7(d)(3) of the Treasury Regulations, the Internal Revenue Service may have argued that section 175.104(C)(1) jeopardized the marital deduction regardless of whether the executor made the QTIP election.

514. Treas. Reg. § 20.2056(b)-7(b)(2) (as amended in 1998).

515. *See* I.R.C. § 2056(b)(1) (2000); Treas. Reg. § 2056(c)-2(b)(1)(iii) (as amended in 1994).

516. UNIF. PRINCIPAL & INCOME ACT § 104 cmt. (amended 1997), 7B U.L.A. 146 (2000).

517. *See* Treas. Reg. § 25.2503-3(b) (as amended in 1983).

518. This is true regardless of whether the remainder was payable to the income beneficiary or to a third person. To value this interest, see § 7520 of the Internal Revenue Code.

adjustments from principal to income because those adjustments would not reduce the value of the income interest. Also, the prohibition would not apply to trusts established or funded at the decedent's death (because those transfers are not subject to the gift tax) or transfers that qualify for the annual exclusion by reason of a beneficiary's possession of a *Crummey* power (even though the beneficiary's income interest might independently qualify for the annual exclusion).[519]

A beneficiary may be entitled to receive annually a fixed dollar amount (an annuity trust) or a fixed percentage of the value of the trust assets determined annually (a unitrust). In these cases, section 175.104(C)(3) makes clear that a beneficiary's right to receive these amounts is not subject to adjustment, helping to effect the settlor's intent. This exclusion protects the charitable deduction in the event that the trust includes charitable income or remainder beneficiaries.[520] It also applies, however, to trusts that do not include charitable beneficiaries. Section 175.104(C)(3) does not proscribe adjustments if the beneficiary is entitled to receive an amount that is tied to the trust's income. For example, a beneficiary may be entitled to receive the greater of a fixed dollar amount or the trust's income. Assuming that the other conditions are satisfied, the trustee may adjust between income and principal for purposes of determining the trust's income.[521]

Section 175.104(C)(4) applies with respect to amounts that are permanently set aside for charitable purposes unless both income and principal are set aside for charity.[522] Because this provision may apply to trusts that do not otherwise qualify for the income or transfer tax deduction, it cannot be justified merely on the basis that it preserves the transfer's expected tax consequences.[523] Rather, the drafters included the provision primarily to protect the charity's interest by ensuring that the settlor's intent is enforced.[524]

519. *See* Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968); RICHARD B. STEPHENS ET AL., FEDERAL ESTATE AND GIFT TAXATION ¶ 9.04[3][f] (7th ed. 1997).

520. Generally, an estate tax charitable deduction is denied for split interests in trusts unless the trust satisfies the requirements in § 2055(e) of the Internal Revenue Code. With respect to the deduction for gift tax purposes, see § 2522(c) of the Internal Revenue Code. With respect to the deduction for income tax purposes, see § 170(f) of the Internal Revenue Code.

521. UNIF. PRINCIPAL & INCOME ACT § 104 cmt. (amended 1997), 7B U.L.A. 146 (2000).

522. A trust in which both income and principal is set aside for charitable purposes generally qualifies for the charitable income, gift, and estate tax deductions, even though a trustee has discretion to adjust between income and principal. *See* I.R.C. §§ 170, 2522, 2055 (2000).

523. Section 175.104(C)(3) preserves the tax consequences for most split-interest charitable trusts. *See* discussion *supra* notes 520-21 and accompanying text.

524. To determine whether this better protects the charity's interest, one must compare the charity's ability to set aside the exercise of the trustee's discretion to make an adjustment that it determines to be against its interest with its ability to require the trustee to administer the trust impartially when the trustee does not possess the power to make an adjustment. In either case,

Under the grantor trust rules, tax law may treat the settlor or a third person as the owner of a trust, and the trust's income may be taxed directly to that person.[525] If the trustee's possession or exercise of a power of adjustment results in either the settlor or a third person being treated as the owner of the trust and if the IRS would not otherwise treat that person as the owner, section 175.104(C)(5) eliminates the trustee's power to make an adjustment. This prohibition preserves the settlor's and beneficiaries' anticipated income tax consequences. If there is more than one trustee, a cotrustee to whom the relevant tax provision does not apply may adjust unless the trust instrument prohibits the exercise of the power by the remaining trustees.[526]

Section 175.104(C)(7) restricts the trustee's power to make an adjustment if the trustee is a beneficiary of the trust,[527] and section 175.104(C)(8) applies if the adjustment would otherwise benefit the trustee directly or indirectly. The drafters obviously intended to protect the other beneficiaries when the trustee has a clear conflict of interest. To determine whether this better protects the other beneficiaries' interests, however, one must compare their ability to set aside the exercise of the trustee's adjustment discretion that they determine to be against their interest with their ability to require the trustee to administer the trust impartially when the trustee does not possess the power to make an adjustment. For example, assume that the trustee holds a remainder interest in a trust, with the income payable for a period of years to a third person. If the trustee invests as a prudent person in stocks that yield little dividends, the income beneficiary's remedy is to rely on the fiduciary's general obligation to be impartial as expressed in section 175.103. Section 175.104 does not require the trustee to make an adjustment between income and principal. If there is more than one trustee, a cotrustee who is not a trust beneficiary or who would not benefit directly or indirectly may make the adjustment unless the trust instrument prohibits the exercise of the power by the remaining trustees.[528]

Section 175.104(E) authorizes the trustee to release or partially release the power to adjust if the trustee is uncertain about whether possessing that power will cause the adverse tax consequences described in sections 175.104(C)(1)-(6) or whether the exercise would benefit the trustee as described in section 175.104(C)(8). The trustee also may release the power if its possession may

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it is clear that the settlor is in the best position to prevent abuse by either the proper drafting of the trust provisions or by the judicious selection of the trustee.

525. *See* I.R.C. §§ 671-679 (2000).

526. 60 OKLA. STAT. § 175.104(D) (2001).

527. This is true regardless of whether the trustee is an income or remainder beneficiary. *See id.* § 175.104(C)(7).

528. UNIF. PRINCIPAL & INCOME ACT § 104(d) (amended 1997), 7B U.L.A. 143 (2000).

result in any adverse tax consequences not detailed in section 175.104(C). The comments provide an example:

> For example, if possessing the power would diminish the actuarial value of the income interest in a trust for which the income beneficiary's estate may be eligible to claim a credit for property previously taxed if the beneficiary dies within ten years after the death of the person creating the trust, the trustee is permitted under subsection (e) to release just the power to adjust from income to principal.[529]

b) Exercise of Discretion

Prerequisites to discretion aside, section 175.104(B) sets forth the specific factors that a trustee must consider, when relevant, in deciding whether to exercise its discretion to adjust between income to principal:

> 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.[530]

529. *Id.* § 104 cmt., 7B U.L.A. at 146.
530. 60 OKLA. STAT. § 175.104(B) (2001).

The trustee must also factor the circumstances that it considered when investing the trust assets as set forth in the Oklahoma Uniform Prudent Investor Act.[531] In other words, the manner in which the trustee invests the assets has a direct bearing on whether it should adjust between income and principal. If the trustee decides that the trust investments should primarily comprise assets whose return will result principally from capital appreciation, the trustee may decide at the time of investment to make future adjustments under section 175.104. If the trustee determines that the trust is best served by investments that yield primarily interest and dividends, however, the trustee may decide that an adjustment is inappropriate.[532]

It is important again to note that the statute grants the trustee discretion to adjust between income and principal and does not mandate the exercise of that discretion. The normal rules that govern a fiduciary's exercise of discretion also apply with respect to the power to adjust.[533]

4. Exercise of Discretion and Judicial Review

In many different contexts, the OUPIA grants the trustee discretion when making specific decisions.[534] In addition, the governing instrument may also grant the trustee discretion regarding decisions that affect the allocation of receipts or disbursements or other issues within the scope of the Act.[535] Nevertheless, that discretion is not unfettered, and the OUPIA acknowledges that a court may intervene to prevent its abuse.[536] The OUPIA does not adopt a specific standard of review. Rather, all discretionary powers contained in the OUPIA are subject to existing general rules that govern the exercise of discretionary powers.[537]

Courts in the exercise of their equitable jurisdiction have the power to protect the interests of a trust's beneficiaries by compelling the trustee to perform its duties in accordance with the governing instrument and state law.[538] If the trustee is granted discretion in the performance of a duty, the court will intervene only if the trustee has abused that discretion.[539]

531. *Id.* § 175.62(C). The circumstances set forth in section 175.62(C) are, in fact, the source of the factors found in sections 175.104(B)(3)-(6) and (8).

532. UNIF. PRINCIPAL & INCOME ACT § 104 cmt. (amended 1997), 7B U.L.A. 145 (2000).

533. 60 OKLA. STAT. § 175.104(B) (2001).

534. *See, e.g., id.*

535. The governing instrument controls to the extent that it is inconsistent with the OUPIA. *See supra* Part II.A.1.

536. 60 OKLA. STAT. § 175.104(A) (2001).

537. UNIF. PRINCIPAL & INCOME ACT § 104 cmt. (amended 1997), 7B U.L.A. 144 (2000).

538. Stallard v. Johnson, 1941 OK 199, 116 P.2d 965.

539. *See* RESTATEMENT (SECOND) OF TRUSTS § 187 (1959); *see also* Buck v. Cavett, 1960

Note the implication: the trustee must exercise some discretion.[540] Thus, if a trustee never inquires about the factors relevant to the exercise of its discretion and arbitrarily exercises or fails to exercise a power, a court will intervene.[541] In such a case, the court need not find that the trustee has abused its discretion. The court may consider the relevant facts and may direct the trustee with respect to the exercise of discretion.

No Oklahoma cases discuss the required scope of the trustee's inquiry. Other jurisdictions have determined, however, that the inquiry must be adequate to permit the trustees to exercise discretion "with the soundness of judgment which follows from a due appreciation of her trust responsibility."[542] This requires a more thorough investigation than one might initially believe. For example, in *Old Colony Trust Co. v. Rodd*,[543] a trustee sent a questionnaire to support beneficiaries to determine which beneficiaries required assistance.[544] The trustee, however, failed to make further inquiry where the answers were incomplete.[545] The court determined that the trustee failed to make adequate inquiry for purposes of exercising its discretion.[546] If the trustee fails to make an adequate inquiry, a court has discretion to exercise the power without first determining that the trustee's exercise was an abuse of discretion.[547]

Assuming that the trustee first makes an adequate inquiry, the issue becomes whether a court will determine that the trustee abused its discretion. Initially, it is clear that the trustee's decision will be subject to judicial review. For example, in *Stallard v. Johnson*,[548] the settlor directed the trustee "to expend from time to time so much of the income and of the principal of said trust estate as shall seem meet and proper for the comfort, maintenance and support of my beloved wife . . . and my beloved sister."[549] The trustee paid $15 per month to the sister, and the sister filed an action requesting a court to direct the trustee to increase the monthly payment to $75.[550] The trustee contended that the trust gave him absolute power and authority to determine

OK 150, 353 P.2d 475; Stallard v. Johnson, 1941 OK 199, 116 P.2d 965; Robinson v. Kirbie, 1990 OK CIV APP 45, 793 P.2d 315.

540. *See Stallard*, ¶ 6, 116 P.2d at 967; RESTATEMENT (SECOND) OF TRUSTS § 187 (1959).

541. RESTATEMENT (SECOND) OF TRUSTS § 187 cmt. h (1959).

542. Boyden v. Stevens, 188 N.E. 741, 743 (Mass. 1934).

543. 254 N.E.2d 886 (Mass. 1970).

544. *Id.* at 888.

545. *Id.*

546. *Id.* at 889-90.

547. *Id.* at 889.

548. 1941 OK 199, 116 P.2d 965.

549. *Id.* ¶ 2, 116 P.2d at 966.

550. *Id.* ¶ 3, 116 P.2d at 966.

how and in what manner he should provide for the beneficiaries' maintenance.[551] The Oklahoma Supreme Court disagreed:

> [W]e find that it has been held, where the question has been properly submitted, that the discretion vested in a trustee must be fairly and reasonably exercised and if not then the same will be compelled by a court of equity. It likewise has been held that the courts in the exercise of their equitable jurisdiction have the power and duty of safeguarding the rights of the cestui que trust and of compelling the performance by the trustee of the duties of his trust.[552]

A court will not deem a fiduciary's decision an abuse of discretion merely because the court would have exercised the power differently or not at all. The trustee, however, must exercise the discretion honestly, fairly, and reasonably to accomplish the purposes for which the settlor established the trust.[553]

The *Restatement* sets forth the following factors that a court should consider when determining whether the trustee has abused discretion in exercising or failing to exercise a power:

> (1) the extent of the discretion conferred upon the trustee by the terms of the trust; (2) the purposes of the trust; (3) the nature of the power; (4) the existence or non-existence, the definiteness or indefiniteness, of an external standard by which the reasonableness of the trustee's conduct can be judged; (5) the motives of the trustee in exercising or refraining from exercising the power; (6) the existence or nonexistence of an interest in the trustee conflicting with that of the beneficiaries.[554]

A court will intervene if it determines that the trustee has acted dishonestly, even if the trustee's actions otherwise would have been within the scope of the trustee's discretion.[555] Thus, if a beneficiary pays the trustee money to influence the exercise of its discretion, a court will set aside the

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551. *Id.*

552. *Id.* ¶ 6, 116 P.2d at 967 (citations omitted). In holding that the trustee had abused his discretion, the court determined that his actions were a travesty upon justice and a cause for righteous reproach of the courts. *Id.*

553. Buck v. Cavett, 1960 OK 150, ¶ 12, 353 P.2d 475, 477-78; *Stallard*, ¶ 6, 116 P.2d at 967.

554. RESTATEMENT (SECOND) OF TRUSTS § 187 cmt. d (1959).

555. *Id.* § 187 cmt. f.

trustee's act.[556] A court will also intervene if the trustee acts from an improper motive, even though the motive is not dishonest.[557] For example, if a trustee has authority to sell real estate if the sale is in the best interest of the trust, but refuses to sell to a buyer on the basis that she will use the land in a manner that would adversely affect the trustee's nearby individually owned land, a court will order the sale if it is in the best interests of the trust's beneficiaries.[558]

A court will be more willing to intervene if the exercise of the trustee's discretion is linked to a standard, such as support or maintenance. For example, if a trust instrument requires a trustee to make distributions it deems necessary for a beneficiary's support, a court will intervene and require the trustee to pay the beneficiary at least the minimum amount determined to be reasonably necessary for the beneficiary's support.[559] A court will also intervene if the trustee applies more than the maximum amount that could be reasonably required for support. This still leaves the trustee considerable discretion to make distributions that exceed the minimum amount reasonably required but which are still less than the maximum amount.[560]

If the trustee's discretion is not tied to a standard, it is more difficult for a court to review the reasonableness of the trustee's decision. This, however, does not eliminate judicial review. A court will intervene if the trustee acts dishonestly or from improper motives, or if the trustee makes an extraordinary decision that defeats a purpose for which the settlor established the trust. The comments to the *Restatement* contain the following example:

> A bequeaths $100,000 to B in trust to pay the income to C for life with a provision that B may if he chooses pay any amount not exceeding $1,000 a year from the income to D during the life of C. B, acting in good faith and from proper motives, refrains from

556. *Id.*

557. *Id.* § 187 cmt. e.

558. *Id.* § 187 cmt. g. This is true even though it might not have been an abuse of the trustee's discretion if the trustee had acted from a proper motive in making the same decision. Note also that the trustee's motives and possible conflicts of interest are factors that a court should consider when determining whether a trustee has abused its discretion.

559. RESTATEMENT (SECOND) OF TRUSTS § 187 cmt. i (1959).

560. The illustrations in the *Restatement* indicate that if the trustee distributes less than the minimum amount reasonably required, a court may order the trustee to distribute only the minimum amount. *Id.* A court generally should not substitute its decision for that of the trustee. Similarly, if the trustee distributes more than the maximum amount reasonably required, a court should order the distribution of the maximum amount.

making any payment to D. The court will not direct B to make any payment to D.[561]

A settlor cannot eliminate judicial review of the trustee's actions. It is against public policy for a settlor to relieve a trustee of all accountability.[562] Even if the settlor grants the trustee absolute, unlimited, or uncontrolled discretion, the trustee must still act consistently with the state of mind contemplated by the settlor.[563] Thus, a court should intervene if the trustee makes an extraordinary decision that would defeat a purpose for which the settlor established the trust.

The power to adjust between income and principal as authorized by section 175.104 only applies where the trustee determines that its administration of the trust is not fair and reasonable to all beneficiaries.[564] The normal rules governing the exercise and review of the trustee's discretion outlined above also apply to the trustee's power to adjust.[565] A court should not intervene in the exercise of the trustee's discretion unless it determines that the trustee has abused its discretion, which would include the relevancy and weight that the trustee assigned to the factors enumerated in section 175.104(B).

In most cases, a trustee will act honestly and without improper motivation. As a result, in reviewing a trustee's action or inaction with respect to the power to adjust between income and principal, the issue generally becomes whether the trustee acted beyond the bounds of reasonable judgment. Because the exercise of the trustee's standard is linked to an express statutory standard,[566] a court should be willing to intervene more frequently than if there were no standard. Disgruntled beneficiaries should be warned, however, that it is unlikely that courts will be anxious to second guess the trustee's decision if the trustee acted honestly and without improper motivation.

C. Apportionment at End of Income Interest

The preceding sections discuss apportionment and allocation issues at the commencement and throughout the administration of the income interest. Section 175.303 sets forth the rights of an income beneficiary to undistributed income at its end. Undistributed income is the net income received before the date on which the income interest terminates.[567] The statute explicitly

561. RESTATEMENT (SECOND) OF TRUSTS § 187 cmt. i, illus. 13 (1959).

562. *Id.* § 172 cmt. d.

563. *Id.* § 187 cmt. j.

564. 60 OKLA. STAT. § 175.103(B) (2001).

565. UNIF. PRINCIPAL & INCOME ACT § 104 cmt. (amended 1997), 7B U.L.A. 143 (2000).

566. The trustee must determine that it is unable to comply with section 175.103(B) and must consider, when relevant, the factors listed in section 175.104(B).

567. 60 OKLA. STAT. § 175.303(A) (2001). Section 175.102(8) defines "net income" as the

excludes from this amount income and expenses that are due or that have accrued.[568] This rule applies to periodic payments of rent, interests, and dividends, as well as to other items of income and expense that accrue over longer periods of time.[569] In essence, the trustee uses the cash accounting method to compute the trust's undistributed income.

The OUPIA only entitles beneficiaries of mandatory income interests to receive the undistributed income on termination.[570] If the income interest terminates as the result of the death of the mandatory income beneficiary, the trust must pay the beneficiary's share of the undistributed income to her estate. If the interest terminates for some other reason, the trust pays the undistributed income to the income beneficiary.

A special rule applies if the income beneficiary has the power to revoke more than 5% of the trust immediately before the termination of the income interest.[571] The OUPIA adds to principal the portion of the undistributed income attributable to that portion of the trust that the income beneficiary could revoke. Although this rule may seem counterintuitive, the comments explain its origin. Without this exception, a revocable trust's undistributed income would be payable to the settlor's estate on death, assuming that the settlor is the mandatory income beneficiary.[572] A typical settlor would prefer to have the undistributed income pass pursuant to the trust terms rather than the terms of her will.[573]

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total receipts allocated to income less the disbursements made from income, as adjusted by authorized transfers between income and principal.

568. This is consistent with the Drafting Committee's conclusion that most settlors would prefer to have undistributed income pass to the remainder beneficiary rather than to the income beneficiary's estate. UNIF. PRINCIPAL & INCOME ACT § 303 cmt. (amended 1997), 7B U.L.A. 158 (2000). Prior Oklahoma law entitled the income beneficiary to net income that had accrued as of the end of the income interest. *See* 60 OKLA. STAT. § 175.28 (1991).

569. 60 OKLA. STAT. § 175.303 (2001).

570. *Id.* § 175.303(B). Section 175.102(6) defines "income interest" to include both mandatory and discretionary income interests.

571. This rule applies only if the beneficiary possesses a power over greater than 5% of the trust assets. If a beneficiary possesses a mandatory income interest and the annual power to withdraw the greater of $5000 or 5% of the trust assets, the beneficiary generally receives all undistributed income when the income interest terminates. If the trust has less than $100,000 in assets, however, a portion of the undistributed income is added to principal, this amount being equal to the undistributed income times a fraction, the numerator of which is $5000 and the denominator of which is the value of the trust assets when the income interest terminates. *Id.* § 175.303(B).

572. *Id.*

573. Without this exception, the comments indicate that the undistributed income would be payable to the settlor's estate even if the settlor's will pours over into the revocable trust, a common estate planning technique. UNIF. PRINCIPAL & INCOME ACT § 303 cmt. (amended 1997), 7B U.L.A. 158 (2000). It is likely in this situation that the undistributed income would

The OUPIA does not limit the application of the 5% rule to revocable trusts. Assume that a beneficiary has a mandatory income interest until the beneficiary attains age 55, when she possesses the right to withdraw 25% of the trust assets. If she fails to exercise this right, the trust assets are distributed outright to her children. Because she has a mandatory income interest and because she had the power to withdraw 25% of the trust, the trustee must distribute to her 75% of the undistributed income and must accumulate for distribution to her children the 25% attributable to that portion of the trust assets that she could withdraw.

If the trust entitles a beneficiary to receive either a fixed annuity or a fixed fraction of the value of the trust's assets, the trustee must prorate the final payment if it is necessary to achieve intended income, gift, estate, or other tax consequences.[574] For example, assume that the settlor established a testamentary charitable remainder annuity trust which provides for the payment of a fixed annuity to a beneficiary for life, and after her death, to charity. To qualify the trust for a partial charitable deduction for estate tax purposes, the trustee must prorate the last payment on a daily basis for purposes of determining the beneficiary's final distribution.[575] To preserve the charitable deductions, the OUPIA places the same obligation on the trustee.

The rules in sections 175.201 to 175.202 relating to the determination of an estate's net income during administration[576] also apply to trusts after an income interest terminates. To understand the effect of those provisions on trust accountings, it is important first to define a terminating income interest.

An income interest is "the right of an income beneficiary to receive all or part of [a trust's] net income, whether the terms of the trust require it to be distributed or authorize it to be distributed in the trustee's discretion."[577] An income interest normally terminates when the income beneficiary dies. However, if a beneficiary is entitled to income for a specific period of time, the income interest terminates upon the expiration of that period. Further, there is no requirement that the beneficiary's rights extend to all of the trust's income. Thus, if a trustee distributes one-half of a trust's net income to a beneficiary for life and the remainder is accumulated, there is a terminating income interest when the beneficiary dies.

A trust that provides for income to a beneficiary for life with the remainder passing outright terminates on the death of the income beneficiary. A more

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return to the trust even without the statutory exception, although it would subject the income to estate administration.

574. 60 OKLA. STAT. § 175.303(C) (2001).

575. *See* Rev. Proc. 90-32, 1990-1 C.B. 546.

576. *See supra* Part III.B.

577. 60 OKLA. STAT. § 175.102(6) (2001).

complex trust, however, may have a number of either concurrent or successive income interests. If so, the trust does not end when an income interest terminates. Even if the trust terminates, the trustee's powers continue during the period required to complete its administration and to make final distribution to the remainder beneficiaries.[578] Thus, the comments define a terminating income interest as "one that has ended but whose administration is not complete."[579]

The comments provide specific guidance when there is more than one income interest:

> If two or more people are given the right to receive specified percentages or fractions of the income from a trust concurrently and one of the concurrent interests ends, e.g., when a beneficiary dies, the beneficiary's income interest ends but the trust does not. Similarly, when a trust with only one income beneficiary ends upon the beneficiary's death, the trust instrument may provide that part or all of the trust assets shall continue in trust for another income beneficiary. While it is common to think and speak of this (and even to characterize it in a trust instrument) as a "new" trust, it is a continuation of the original trust for a remainder beneficiary who has an income interest in the trust assets instead of the right to receive them outright. For purposes of this Act, this is a successive income interest in the same trust. The fact that a trust may or may not end when an income interest ends is not significant for purposes of this Act.[580]

The comments confirm that sections 175.201 to 175.202 apply to terminating income interests irrespective of whether the trust ends simultaneously with the income interest. If assets subject to a terminating income interest pass to another trust, as where the income beneficiary exercises a general power of appointment over them, the recipient trust would be a new trust.[581] For purposes of the OUPIA, however, the new trust created in these circumstances is also a successive income interest subject to the provisions of sections 175.201 to 175.202.[582]

Although the definition of a terminating income interest is very broad, the application of the rules in sections 175.201 to 175.202 is more limited. Terminating income interests are included within the scope of sections

578. UNIF. PRINCIPAL & INCOME ACT § 201 cmt. (amended 1997), 7B U.L.A. 151 (2000).
579. *Id.*
580. *Id.*
581. *Id.*
582. *Id.*

175.201 to 175.202 so that the estate rules will apply in those situations in which the administration of the trust is comparable to an estate's administration.[583] In other words, rules relating to terminating income interests apply when gifts of specific property, pecuniary gifts, or the trust's termination follow the income interest. For example, consider a self-settled revocable trust with a retained life estate in the settlor and outright distribution of the remainder upon her death. This is a classic will substitute. Upon the settlor's death, the comparison of the trust's administration with an estate administration becomes unavoidable, and the same rules should apply to each.

Assume that a testamentary trust provides for income to *A* for life, and then income to *B* for life. On *B*'s death, the trust terminates, and the trustee makes outright transfers to remainder beneficiaries. When *A* dies survived by *B*, *A*'s income interest terminates. The rules relating to the apportionment of receipts and disbursements during the transition period, however, are found in Article 3, which discusses allocations at the beginning and end of income interests.[584] When *B*'s income interest terminates, sections 175.201 to 175.202 apply because there are outright distributions that follow the termination of *B*'s income interest.

The apportionment rules relating to terminating income interests are not limited to those assets that generate the income interest that ends. Assume that a trust provides that the trustee must distribute income equally to *A* and *B*. On the death of the first income beneficiary, income from her interest is accumulated and added to principal. On the death of the last to die, the trust terminates, and the trustee makes outright transfers to the remainder beneficiaries. Assuming *A* dies first, the rules with respect to terminating income interests do not apply. The amount of the final income distribution to *A* is determined in accordance with sections 175.301 to 175.303, and the remainder of the income attributable to *A*'s one-half is accumulated. On *B*'s death, sections 175.201 to 175.202 apply to the outright distribution of all of the trust assets, even though the terminating income interest only represents income from one-half of the trust assets.[585]

583. *Id.* § 202 cmt., 7B U.L.A. at 154.

584. *See* 60 OKLA. STAT. §§ 175.301-175.303 (2001).

585. A trustee determines the amount of the final income distribution to *B* in accordance with the rules set forth in sections 175.301 to 175.303. For a discussion of the rules relating to the allocation of receipts and disbursements as those rules apply to terminating income interests, see section 175.201. For information with respect to distributions to residuary and remainder beneficiaries, see section 175.202.

D. Allocation as Affects Estate Administration/Decedent's Estates

Because estates are not administered for extended periods and because the income and principal often pass to the same beneficiary, the determination and distribution of an estate's net income are less important than that of a trust. The estate's beneficiaries, however, might disagree, and issues relating to the allocation of receipts and disbursements between income and principal remain. It is equally important to determine who receives the net income absent an express provision in a will.[586]

The OUPIA deals principally with the allocation of receipts and disbursements in a trust setting. Articles 3,[587] 4,[588] and 5[589] refer specifically to trusts and trustees. These articles also apply generally with respect to the determination of an estate's net income,[590] as section 175.201 reflects.

If an estate's net income and principal are distributable to the same beneficiary, the determination of the estate's net income may be considered an academic exercise in fiduciary accounting.[591] This is the case in a simple estate where the decedent's residue is payable to a single beneficiary.[592] An estate's net income, however, does not necessarily follow the distribution of an estate's residue. For example, the determination of an estate's net income affects the amounts beneficiaries receive if the will provides for a pecuniary gift in trust[593] or the executor makes disproportionate residuary distributions.[594]

If a beneficiary receives a gift of specific property, the beneficiary is also entitled to receive the net income and net principal receipts that the property generates during administration.[595] A trustee must determine these amounts

586. This latter issue is generally unique to an estate because the trust instrument usually identifies the income beneficiary and defines her rights to the income.

587. *See* 60 OKLA. STAT. §§ 175.301-175.303 (2001) (relating to apportionment at the beginning and end of an income interest).

588. *See id.* §§ 175.401-175.415 (relating to the allocation of receipts).

589. *See id.* §§ 175.501-175.506 (relating to the allocation of disbursements).

590. *Id.* § 175.201(1).

591. One should not confuse the calculation of an estate's accounting income with the computation of its taxable income for federal income tax purposes, an exercise which is never academic.

592. This also assumes that the decedent did not make a pecuniary gift in trust, which is also entitled to receive a portion of the estate's net income. *See* 60 OKLA. STAT. § 175.201(4) (2001).

593. In this case, the trust is entitled to a portion of the estate's net income. *See id.*

594. Section 175.202 mandates a complicated allocation of net income if an executor makes disproportionate residuary distributions.

595. 60 OKLA. STAT. § 175.201(1) (2001). A 1958 revision to the 1931 Uniform Principal and Income Act provides for the same result, but Oklahoma never enacted that version. *See*

pursuant to the rules in Articles 3 through 5 and the rules in section 175.201(5). The net receipts include all amounts that the executor receives or pays with respect to the property, including amounts accruing before and after the decedent's death.[596] The OUPIA also directs the executor to make reasonable provision for amounts that it believes the estate may be obligated to pay after the property is distributed.[597]

In determining the net receipts generated by a gift of specific property, the fiduciary should take into account federal and state death taxes to the extent that the beneficiary must pay those taxes.[598] If the taxes exceed the net income and principal receipts, the beneficiary must reimburse the estate for the excess.[599] The executor may not reduce the net income and principal receipts because of disbursements related to the property if the will or applicable law requires the executor to make payment from other assets or if the executor recovers, or expects to recover, the payment from a third party.[600]

Section 175.201(1) applies only to property specifically given to a beneficiary. In the case of an estate, a "beneficiary" is an heir, legatee, and devisee.[601] Although these terms generally refer to individuals, their use in section 175.201(1) is not so restricted. The equitable principles relating to gifts of specific property to entities are the same, and the rules should apply equally to gifts of specific property in trusts.[602]

Assume that a decedent gave her interest in a sole proprietorship to her daughter and the remainder of her estate to her son. The daughter is entitled

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UNIF. PRINCIPAL & INCOME ACT § 3-A (1931), 7B U.L.A. 255-56 (2000).

596. 60 OKLA. STAT. § 175.201(5) (2001).

597. *Id.*

598. The OUPIA treats death taxes as principal disbursements. *See id.* § 175.502(A)(6). For a discussion of equitable apportionment in Oklahoma, see Mark R. Gillett, *Equitable Apportionment in Oklahoma: What Hath the Courts Wrought?*, 45 OKLA. L. REV. 241 (1992).

599. An alternative, of course, would be for the executor to sell the property and distribute the net amount to the beneficiary. With respect to the Oklahoma estate tax, title 68, section 811(a) of the 1991 Oklahoma Statutes provides:

> Every exeeutor, administrator, or trustee shall have full power to sell or to convert into money so much of the property of the decedent or the property of any transferee subject to the tax as will enable him to pay such tax in the same manner as he might be entitled to do by law for the payment of other preferred and secured claims against the decedent.

68 OKLA. STAT. § 811(a) (2001). Title 58, section 381 of the 1991 Oklahoma Statutes similarly authorizes the personal representatives to sell non-exempt property to satisfy federal transfer taxes. *See also* Tapp v. Mitchell, 1960 OK 135, 352 P.2d 900.

600. 60 OKLA. STAT. § 175.201(5) (2001).

601. *Id.* § 175.102(2).

602. In the case of a trust, the beneficiary of the gift should be viewed as the trust beneficiaries rather than the trustee who has only an equitable interest in the property.

to receive the business and the net income and principal receipts (as defined in sections 175.201(1) and (5)) that the estate receives prior to its distribution.[603] If the will directs the executor to pay all taxes from the estate's residue, the daughter's distribution will not be reduced by any taxes attributable to the business. If the will is silent, however, the executor will reduce the daughter's distribution by her proportionate share of federal and state death taxes.[604] Oklahoma law generally charges executor fees and other costs of administration against the estate's residue.[605] As a result, the executor should not take any portion of those expenses into account in determining the business's net receipts during administration, unless the will provides otherwise.[606]

The OUPIA provides that, to the extent interest is due to a beneficiary who receives an outright pecuniary gift, a trustee must first charge that interest against the estate's net income.[607] If the net income is insufficient, the fiduciary must charge the excess against principal. The OUPIA does not expressly provide for the payment of interest on outright cash bequests, but rather gives deference to the terms of the will or applicable law.[608]

The testator's intent as expressed in the will controls whether the executor should pay interest on pecuniary bequests. If the will is silent, Oklahoma law provides that an executor must pay most cash bequests one year after the decedent's death, at which time they begin to accrue interest.[609] If it is a cash bequest to the surviving spouse or for a beneficiary's maintenance, however, the gift accrues interest from the decedent's death.[610] In both instances, the interest rate is 6%.[611] In *Reardon v. McDougal*,[612] the Oklahoma Supreme

603. This includes receipts accrued but not paid prior to the decedent's death. 60 OKLA. STAT. § 175.201(5) (2001).

604. For a discussion of the computational aspects of equitable apportionment, see Gillett, *supra* note 598, at 262-65.

605. *See* 84 OKLA. STAT. § 3 (2001).

606. This is consistent with title 60, section 175.201(2)(b), which grants the executor discretion to charge these expenses against income or principal receipts remaining after allocating receipts and disbursements to gifts of specific property.

607. 60 OKLA. STAT. § 175.201(3) (2001). The statute limits this treatment to pecuniary gifts that a beneficiary receives outright. The OUPIA treats pecuniary gifts in trust the same as residuary gifts for purposes of distributing the estate's income.

608. *Id.*

609. 84 OKLA. STAT. §§ 12-13 (2001).

610. *Id.* § 13. There is no case law that provides guidance on when a testator intends a cash bequest for the beneficiary's maintenance. Although this description may fit most gifts, courts should give it a more restrictive interpretation. Further, although the statute refers to legacies "to the testator's widow," it will be applied equally to widowers.

611. 15 OKLA. STAT. § 266 (2001). If a beneficiary must bring suit to obtain the bequest, interest will accrue on the judgment at the higher rate specified in title 60, section 175.727 of

Court, in dicta, stated that a beneficiary of a cash bequest may not be entitled to interest if the estate administration involves extenuating circumstances, such as will contests or complex tax matters, that preclude the executor from paying the bequest within the statutory period.[613]

Two Oklahoma cases illustrate. In *In re Estate of Sharp*,[614] the court had already determined that the beneficiary was entitled to receive an amount of cash equal to the date of death value of a fractional interest in two entities, and thus it was a pecuniary gift within the meaning of title 84, sections 12 to 13 of the Oklahoma Statutes.[615] Litigation prevented its distribution within the statutory time frame. Although there was no indication that the executor litigated this issue in bad faith, the Supreme Court, in a subsequent action, determined that there were no extenuating circumstances that would prevent interest accruing on the gift.[616]

In *In re Estate of Vaden*,[617] the decedent died on November 8, 1972. As the result of a series of will contests, the executor did not offer to pay cash bequests until nearly ten years later.[618] Specifically ignoring its dicta in *Reardon*, the Supreme Court held that the right to receive interest is an incident to the legacy itself and that the beneficiary is in the same position as a creditor.[619] If there is a delay in the estate's settlement, the value of the cash bequest will be lessened unless the estate pays the statutory interest.[620] Thus, interest is due commencing one year after the decedent's death, regardless of the pendency of a will contest, unless the will expressly provides to the contrary. Although the *Vaden* decision only addressed the effect of a will contest, the court's reasoning is more applicable where the existence of the bequest is certain but its payment is delayed because of the complex nature of the estate's administration.

After determining the net income and principal receipts associated with gifts of specific property, and whether interest is payable with respect to pecuniary bequests, the executor must calculate the estate's remaining net income.[621] The executor first applies the trust accounting rules in Articles 3

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the Oklahoma Statutes. *See In re* Reardon v. McDougal, 1974 OK 44, 524 P.2d 342 (directing the lower court to compute interest at the higher rate from the date of an earlier judgment).

612. 1974 OK 44, 524 P.2d 342.

613. *Id.* ¶ 9, 524 P.2d at 344.

614. 1970 OK 32, 512 P.2d 160.

615. *Id.* ¶ 22, 512 P.2d at 166.

616. *Reardon*, ¶ 9, 524 P.2d at 344.

617. 1983 OK CIV APP 651, 677 P.2d 659.

618. *Id.* ¶¶ 1-4, 677 P.2d at 660-61.

619. *Id.* ¶ 15, 677 P.2d at 665.

620. *Id.*

621. 60 OKLA. STAT. § 175.201(2) (2001). The statute speaks only in terms of the estate's

through 5. The executor must then focus on the special rules in section 175.201(2), which apply only to estates. Initially, note that receipts and disbursements that are allocated to principal generally affect the amount passing to the residuary beneficiaries.[622] Receipts and disbursements that are allocated to the estate's net income inure to the benefit of the estate's residuary beneficiaries and trusts that receive pecuniary gifts.[623]

First, the executor must include in net income all income from property used to discharge the estate's liabilities.[624] For this purpose, income is money or property that a fiduciary receives as current return from a principal asset.[625] Thus, the OUPIA allocates income from property used to discharge an estate's liability to the estate's net income even though the rules in Article 4 might otherwise allocate the receipt to principal.

The executor has discretion to charge attorney fees, accountant fees, executor fees, court costs, and other administration expenses, including interest on death taxes, against income or principal.[626] The executor also has the option to deduct administration expenses, such as executor and attorney fees and casualty losses, on either the estate tax return or the income tax return, but not both.[627] The OUPIA provides for both discretionary and mandatory adjustments if the executor's tax elections shift economic benefits between beneficiaries.[628] If the executor's decision to allocate the administration expenses against income or principal is consistent with the deduction's treatment for tax purposes, it generally eliminates the need to adjust between income and principal. In other words, if the executor claims a deduction for executor fees on the income tax return and charges the deduction against income for accounting purposes, it should avoid a shifting

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net income. Principal receipts inure to the benefit of the residuary beneficiaries, and principal disbursements similarly are charged against the residue.

622. For a complete listing of the order of resort for the payment of principal expenditures, see title 84, section 2 of the Oklahoma Statutes.

623. 60 OKLA. STAT. § 175.201(4) (2001).

624. *Id.* § 175.201(2)(a).

625. *Id.* § 175.102(4). Income also includes a portion of the receipts from a sale, exchange, or liquidation of a principal asset to the extent that receipt is already allocated to income pursuant to Article 4.

626. *Id.* § 175.201(2)(b).

627. Section 642(g) of the Internal Revenue Code provides that deductions allowed for federal estate tax purposes under §§ 2053 or 2054 are not also allowed as a deduction for income tax purposes. This most commonly refers to administration expenses that are allowable for estate tax purposes as provided in § 2053(a)(2) and that are allowable for income tax purposes as provided in § 212 and losses for thefts, fire, and other casualties that are allowable for estate tax purposes as provided in § 2054 and that are allowable for income tax purposes as provided in § 165.

628. *See* 60 OKLA. STAT. § 175.506 (2001).

of economic interests between beneficiaries that would necessitate an equitable adjustment.

The OUPIA limits the executor's discretion to charge administration expenses against the income of property passing to a trust for which the executor claims a marital or charitable deduction if that allocation results in the reduction or loss of the deduction.[629] To understand how this restricts the executor's discretion, it is necessary to examine the interaction between the OUPIA and federal tax law. The following discussion assumes that a gift is made to a trust qualifying for the marital deduction, although the principles are the same if the gift is made to a charitable trust.

An estate receives an estate tax deduction for qualifying transfers to the surviving spouse. Generally, the marital share is reduced by taxes and other administrative expenses payable from the marital gift.[630] Federal regulations define the marital share that qualifies for the marital deduction to include the income produced by property during the period of administration if, under the terms of the governing instrument or state law, that income is payable to the surviving spouse or is added to the principal of the property passing to the surviving spouse.[631] Thus, the threshold question is whether state law entitles the spouse to any portion of the income earned during administration with respect to property passing to a trust that qualifies for the marital deduction.

If the marital trust receives a gift of specific property, the trust is entitled to the net income and principal distributions from that property that the estate receives prior to the distribution to the trustee.[632] Because the OUPIA does not charge general estate administration expenses against the income that gifts of specific property generate, the allocation of the administration expenses against the estate's remaining income will not reduce the marital deduction for federal estate tax purposes if the marital trust receives specific property.[633]

If the gift to the marital trust is expressed as a pecuniary amount or as a portion of the residue, the trust is entitled to a portion of the estate's net income received during administration.[634] This is true regardless of whether the amount passing to the marital trust is fixed or expressed as a formula. In

629. *Id.* § 175.201(2)(b). Note that the cited provision only relates to the allocation of expenses against income generated by property qualifying for the marital or charitable deduction.

630. I.R.C. § 2056(b)(4) (2000); Treas. Reg. § 20.2056(b)-4(c), (d) (as amended in 1999).

631. Treas. Reg. § 20.2056(b)-4(d)(1)(iii) (as amended in 1999).

632. 60 OKLA. STAT. § 175.201(1) (2001).

633. The discretion to allocate administration expenses against income granted to the executor in section 175.201(2)(b) relates only to the estate's net income that remains after first distributing net income and principal receipts relating to a gift of specific property to the beneficiary who receives that property.

634. 60 OKLA. STAT. § 175.201(4) (2001).

this situation, the marital share as defined in the federal regulations includes a portion of the income earned during administration, and the allocation of administration expenses against the income passing to the marital trust might reduce the available marital deduction.[635]

To determine the effect of allocating administration expenses against income when a pecuniary gift or a portion of the residue passes to a trust that qualifies for the marital deduction, the expense must first be categorized as either a management expense or a transmission expense. Management expenses are expenses incurred in connection with the investment of estate assets or with their preservation or maintenance during a reasonable period of administration, such as investment advisory fees, stock brokerage commissions, custodial fees, and interest.[636] Estate transmission expenses are expenses that the estate would not have incurred but for the decedent's death and the consequent necessity of collecting the decedent's assets, paying the decedent's debts and death taxes, and distributing the decedent's property to those who are entitled to receive it.[637] Transmission expenses include any administration expense that is not a management expense. "Examples of these expenses could include executor commissions and attorney fees (except to the extent of commissions or fees specifically related to investment, preservation, or maintenance of the [estate's] assets), probate fees, expenses incurred in construction proceedings and defending against will contests, and appraisal fees."[638]

The amount of estate management expenses that are attributable to and paid from the marital share do not reduce the marital share.[639] The marital deduction *is* reduced, however, by the amount of transmission expenses paid from the marital share and by the amount of management expenses paid from the marital share but which are attributable to property not included in the marital share.[640] This reduction occurs regardless of whether the deduction for those expenses is claimed on the estate or income tax return.[641] Thus, under section 175.201(2)(b), the executor does not have discretion to allocate these

635. *See infra* notes 641-42.

636. Treas. Reg. § 20.2056(b)-4(d)(1)(i) (as amended in 1999).

637. *Id.* § 20.2056(b)-4(d)(1)(ii).

638. *Id.*

639. *Id.* § 20.2056(b)-4(d)(3). If the estate claims a deduction for these expenses on the estate tax return, § 2056(b)(9) of the Internal Revenue Code requires that the marital deduction be reduced by the amount claimed as a deduction under § 2053. Because deductions claimed on the estate tax return do not give rise to income tax savings, however, an adjustment from income to principal under section 175.506(B) is not warranted.

640. Treas. Reg. § 20.2056(b)-4(d)(2), (4) (as amended in 1999).

641. *See, e.g., id.* § 20.2056(b)-4(d)(5), example 1. This should be the case because the estate has expended these amounts, and the spouse will therefore not receive them.

latter expenses against that portion of the income that passes to the marital trust.

Three additional rules apply specifically to estates. First, the executor must charge any interest on pecuniary bequests that are not paid within a year of the decedent's death against the estate's net income.[642] Second, the executor must charge all other disbursements incurred in conjunction with the settlement of a decedent's estate, including the payment of debts, funeral expenses, family allowances, death taxes, and related penalties, against principal.[643] The net effect is to reduce the amount available for distribution to the residuary beneficiaries.[644] Finally, the executor does not have discretion to transfer income to principal to reimburse the principal account for any depreciation that occurs during administration.[645]

Under traditional accounting principles, income received during administration generally passes to the estate's residuary beneficiaries. Under the OUPIA, an estate's net income excludes income and principal receipts from property specifically given to a beneficiary that passes directly to that beneficiary.[646] In addition, beneficiaries who receive pecuniary gifts may be entitled to interest if the bequest is not paid within one year of death.[647] Although the amounts paid to recipients of specific and pecuniary bequests directly affect the estate's remaining net income, these beneficiaries should not be viewed as recipients of the estate's net income. The OUPIA provides that the estate's net income, after taking into account the amounts payable to these beneficiaries, is distributed to the estate's "other beneficiaries" who include residuary beneficiaries (including beneficiaries who receive all or a portion of the residue in trust) and beneficiaries who receive pecuniary amounts in trust.[648]

A beneficiary's share of the estate's net income is equal to the estate's net income determined as of the date of each principal distribution times a fraction, the numerator of which is equal to the value of the beneficiary's interest in undistributed principal assets and the denominator of which is equal to the value of all undistributed principal assets.[649] Both the numerator and the

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642. *See* 60 OKLA. STAT. § 175.201(3) (2001).

643. *Id.* § 175.201(2)(c).

644. For a complete listing of the order of resort for the payment of principal expenditures, see title 84, section 2 of the Oklahoma Statutes.

645. 60 OKLA. STAT. § 175.503(B)(2) (2001).

646. *See id.* § 175.201(1).

647. *See* 84 OKLA. STAT. §§ 12-13 (2001). Interest paid on pecuniary bequests is charged against the estate's income. *See* 60 OKLA. STAT. § 175.501(3) (2001).

648. 60 OKLA. STAT. § 175.201(4) (2001).

649. *Id.* § 175.202(A).

denominator are calculated "without regard to property specifically given to a beneficiary and property required to pay pecuniary amounts not in trust."[650] Thus, if a beneficiary receives both a gift of specific property and a residuary gift, the value of the specific gift is excluded from both the numerator and the denominator.[651]

The beneficiary's fractional interest in the undistributed principal assets is based on the aggregate value of the principal assets without reduction for any unpaid principal obligations.[652] Thus, the denominator includes assets that the estate may be required to sell in the future to meet principal obligations, such as the payment of death taxes.[653] The executor may compute the value of the principal assets as of a date that is reasonably near the date on which the estate actually distributes the principal assets.[654]

Whenever a principal distribution occurs, the executor must compute the beneficiaries' fractional interests in the undistributed principal assets, using updated principal values. The executor must also compute net income that has not already been distributed as of the current distribution date and that the fiduciary has received after the later of the date of death or an earlier principal distribution date. In other words, as of each principal distribution date, the executor must compute the amount of income to which each beneficiary is entitled as of that date. If the executor does not distribute each beneficiary's share of the estate's net income as of a principal distribution date, the executor must maintain records showing each beneficiary's interest.[655]

There is an additional complication. The executor has discretion to apply the above rules with respect to any gain or loss that the estate realizes during administration from the disposition of a principal asset to the extent the income from that asset is included in computing the estate's net income.[656]

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650. *Id.* § 175.202(B)(2). After gifts of specific property are distributed and pecuniary bequests are satisfied, those assets are no longer part of the estate and necessarily should not be included in either the numerator or denominator.

651. It follows that if a beneficiary only receives a gift of specific property, that beneficiary is not entitled to any portion of the estate's net income, although she is entitled to net income and principal receipts related to the property specifically given. *See id.* § 175.201(A). This result is consistent with section 175.201(4), which identifies those beneficiaries entitled to a portion of the estate's net income.

652. *Id.* § 175.202(B)(3).

653. *Id.* § 175.202(B)(1).

654. *Id.* § 175.202(B)(4).

655. *Id.* § 175.202(C). In most cases, the distribution of the estate's income is dictated by income tax considerations. *See* I.R.C. §§ 661-662 (2000).

656. 60 OKLA. STAT. § 175.202(D) (2001). Presumably this would include the gain or loss from the disposition of all assets other than assets that are specifically given to a beneficiary. *See id.* § 175.201(1).

The executor should exercise this discretion in those situations it deems appropriate.[657]

The mechanism for determining and allocating an estate's net income outlined above produces a fair result.[658] If the estate only has one residuary beneficiary, the executor can ignore all of the above computations because that beneficiary is entitled to all of the estate's income.[659] The process can become burdensome, however, if more than one beneficiary is entitled to the estate's net income. If the executor only makes one principal distribution at the end of the estate's administration, there is little additional required work.[660] The burden also can be minimized if the executor always makes proportionate principal distributions to all of the beneficiaries entitled to the estate's net income.[661] In practice, if an executor makes disproportionate distributions, the executor probably will ignore the rules except in those few cases where the executor or beneficiaries are astute and the estate generates sufficient income to justify the additional effort.

IV. Conclusion

In a society where all is fair in love and war and death and taxes are the only constants, one can expect intra-family dissension and even litigation over the allocation of assets and the receipts and expenses they trigger. Assuming the common trust with successive interests, income beneficiaries will prefer income at the expense of capital growth, and remaindermen the reverse. The

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657. Neither the statute nor the comments provide guidance with respect to the exercise of this discretion. This change from the earlier uniform act was in response to past criticism. *See, e.g.*, Thomas H. Cantrill, *Fractional or Percentage Residuary Bequests: Allocation of Postmortem Income, Gain and Unrealized Appreciation*, 10 PROB. NOTES 322 (1985).

658. One perhaps can argue that beneficiaries of pecuniary gifts in trust should not be entitled to a portion of the estate's income, but rather should receive statutory interest if the amount is not paid within one year. Compare section 175.201(3) with title 84, sections 12-13. The OUPIA provides the better result because these gifts are often interrelated with the marital deduction and the federal estate tax return, and the precise amount may not be determinable for an extended period of time. Further, these gifts should be distinguished from outright gifts of a specific dollar amount, which are normally smaller and which the decedent expects to be paid soon after death.

659. This also assumes that there are no pecuniary gifts in trust.

660. The executor will be required to value the assets at the time of distribution. However, this may be necessary to effect the principal distribution in any event unless the executor proportionately distributes each asset to the residuary beneficiaries, a practice that seldom occurs.

661. In this case, each beneficiary's share of the estate's net income remains constant, and the same fractions can be used whenever there is an income distribution. Although this works with respect to residuary distributions, the computation becomes more complicated if the will also includes a pecuniary gift in trust.

trustee is often caught in the middle, impartially balancing a conservative portfolio with growth opportunities in riskier investment vehicles. Couple that attempted stasis with difficult accounting issues throughout the income interest, and the trustee is left with a difficult task indeed.

Oklahoma assists the trustee's ability to negotiate the terrain with the total return theory advocated by the Uniform Prudent Investor Act, under which investment decisions need not be constricted by traditional inflexible doctrines and where the bull, the bear, and the wildcat can all find a proper home. What should be just as welcome to the trustee office, however, is the Uniform Principal and Income Act. By comprehensively answering most income and principal allocation questions — whether at the beginning of the income interest, during its administration, or at its close — the Act promotes consistency, clarity, and efficiency, avoiding the costs and conflicts associated with indistinct fiduciary rules. It also allows the trustee to offset the distorting effects that certain investment strategies can cause by permitting adjustments from income to principal and back again as circumstances warrant. Finally, it strengthens the use of will substitutes, themselves quite adaptable instruments, by integrating their management issues with similar concerns within the testamentary estate context.

Even the most effective tool, however, is worthless to those who do not know it exists or do not know how to use it. Oklahoma's recent passage of the Act and the lack of reported opinions explaining it suggest that practitioners' attention to its provisions might not be as acute as warranted. Only by familiarity with the Act and appreciation for when its provisions should be invoked or avoided will the Oklahoma estate bar be able to realize fully its potency and its potential, both in making initial investment decisions and in responding to the accounting issues that thereafter arise.