MAYNARD NEXSEN

ALABAMA PRINCIPAL AND INCOME ACT

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Introduction

- *Income to A for life, in Trustee's sole discretion, remainder to B*

MAYNARDNEXSEN

Introduction

- In general terms, the principal and income act is a set of accounting rules to be used by trustees and other fiduciaries, such as estate executors, in allocating receipts and expenditures of the estate or trust between the entity's principal and income accounts.
- This accounting determines the amount distributable to an income beneficiary when the right of that beneficiary to receive distributions is based on the income of the estate or trust.
  - Apportionment of a receipt to the income account will increase the amount distributable to the income beneficiary, but if it is apportioned to the principal account it will not.
  - Conversely, apportionment of an expense item to the income account will reduce distributions to the income beneficiary, while apportionment of that item to the to principal account will not.

Introduction

- The principal and income act characterizes these rules as defaults which will apply unless, and to the extent, they are not overridden in the governing instrument. This feature allows the draftsperson the unique ability to write rules into a will or trust to determine fiduciary accounting income in a manner most suitable to that entity and the requirements of its beneficiaries.
- Alabama, Florida (F. S. A. § 738.101, FL ST § 738.101) and Mississippi (Miss. Code Ann. § 91.17.101, et. al.) have all adopted a Principal and Income Act based on the 1997 Revised Principal and Income Act. There were two prior versions adopted in 1931 and 1962.
- Louisiana has not adopted the Uniform Principal and Income Act; however, it has has adopted similar rules in dealing with allocation of principal and income, including important concepts like the power to adjust (see subparts D and E of the Louisiana Trust Code).
- The Uniform Fiduciary Income and Principal Act was adopted by the Uniform Law Commission in 2018 and has been adopted 6 states.

General Principles, Duties and Definitions

- Section 102 of the Act provides a list of definitions of terms used for interpreting the principal and income act.
- Although all three states adopted Section 102 of the uniform Act, Alabama and Florida made some adjustments by adding terms not found in the uniform Act.
- For example, Alabama added three new defined terms to its version of the Act, including
  - Presumptive Remainder Beneficiary
  - Unitrust Amount
  - Inventory Value
- Florida added the defined term “Carrying Value” to its version of the Act.

General Principles, Duties and Definitions

- Section 103(a) of the Act makes clear that the provisions of the principal and income act are default rules. To the extent the terms of the will or trust provide different rules from the principal income act, a trustee must allocate receipts and disbursements among principal and income in accordance with the terms of the trust or will, whether or not it creates a result different from that under the UPIA.
- In other words, an attorney can draft trust or will instruments to avoid the default rules provided under the Act.
- Section 103(b) makes clear that the trustee has a duty of impartiality when exercising the power to adjust between principal and income (discussed below), "based on what is fair and reasonable to all of the beneficiaries, except to the extent that the terms of the trust or the will clearly manifest an intention that the fiduciary shall or may favor one or more of the beneficiaries."
- Alabama, Florida and Mississippi all adopted Section 103 of the Act, with minor changes

Trustee's Power to Adjust

- In order to enable a trustee to select investments using the standards of a prudent investor without having to realize a particular portion of the portfolio's total return in the form of traditional trust accounting income, the principal and income act allows the trustee the power to adjust between income and principal.
- This is one of the two significant changes that the 1997 version added to the uniform Act.
- Alabama, Mississippi, Florida all adopted Section 104 of the Uniform Act, but each added it's own special provisions not found in the Uniform Act.
- The Louisiana Trust Code did not adopt the Uniform Principal and Income Act; however, the Louisiana Trust Code has adopted the power to adjust, with concepts similar to the Uniform Act.

Trustee's Power to Adjust

- Section 104(a) allows the trustee to adjust between principal and income if the following requirements are met:
  - The trustee invests and manages trust assets as a prudent investor
  - The terms of the trust describe the amount that may or must be distributed to a beneficiary by referring to the trust's income
  - The trustee determines she cannot exercise her duty of impartiality after applying the provisions of the principal and income act or the trust or will instrument
- In addition, Alabama requires the terms of the trust to expressly provide for the power to adjust by specific reference to Ala. Code Section 19-3A-104
- This extra requirement is not found in the Uniform Act, Florida's version of the Act or Mississippi and may cause problems for trustees when and if they need to exercise the power to adjust

Trustee's Power to Adjust

- Section 104(b) provides a non-exhaustive list of factors the Trustee must consider before exercising her power to adjust, including:
  - The nature, purpose, and expected duration of the trust
  - The intent of the settlor
  - The identity and circumstances of the beneficiaries
  - The needs for liquidity for the trust and regularity of income to the trust
  - The nature of the assets held in the trust and 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
  - Whether an asset was purchased by the trustee or received from the settlor

Trustee's Power to Adjust

- Section 104(b) provides a non-exhaustive list of factors the Trustee must consider before exercising her power to adjust, including:
  - The net amount allocated to income under the other sections of this chapter 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
  - Whether and to what extent the terms of the trust a. give the trustee the power to invade principal or accumulate income, or b. prohibit the trustee from invading principal or accumulating income
  - The extent to which the trustee has exercised a power from time to time to invade principal or accumulate income
  - The actual and anticipated effect of economic conditions, inflation, and deflation upon principal and income
  - The anticipated income and transfer tax consequences of an adjustment
  - The need for preservation and appreciation of capital

Trustee's Power to Adjust

- Section 19-3A-104(c) provides a list of prohibitions on trustee's power to adjust, including any adjustment:
  - That diminishes the income interest in a trust that requires all of the income to be paid at least annually to a spouse and for which an estate tax or gift tax marital deduction would be allowed, in whole or in part, if the trustee did not have the power to make the adjustment
  - That reduces the actuarial value of the income interest in a trust to which a person transfers property with the intent to qualify the transfer for a gift tax exclusion
  - That changes the amount payable to a beneficiary as a fixed annuity or a fixed fraction of the value of the trust assets The actual and anticipated effect of economic conditions, inflation, and deflation upon principal and income

Trustee's Power to Adjust

- Section 19-3A-104(c) provides a list of prohibitions on trustee's power to adjust, including any adjustment:
  - That changes the amount that is permanently set aside for charitable purposes under a will or the terms of a trust, unless both income and principal are so set aside
  - If possessing or exercising the power to make an adjustment causes an individual to be treated as the owner of all or part of the trust for income tax purposes, and the individual would not be treated as the owner if the trustee did not possess the power to make an adjustment
  - If possessing or exercising the power to make an adjustment causes all or part of the trust assets to be included for estate tax purposes in the estate of an individual who has the power to remove a trustee or appoint a trustee, or both, and the assets would not be included in the estate of the individual if the trustee did not possess the power to make an adjustment

Trustee's Power to Adjust

- Section 104(c) provides a list of prohibitions on trustee's power to adjust, including any adjustment:
  - If the trustee is not a beneficiary, but the adjustment would benefit the trustee directly or indirectly
  - If the trustee is a beneficiary of the trust
  - If the trust is an express unitrust or is a unitrust by reason of a conversion

Trustee's Power to Adjust

- Section 104(c) provides a list of prohibitions on trustee's power to adjust, including any adjustment:
  - If the trustee is not a beneficiary, but the adjustment would benefit the trustee directly or indirectly
  - If the trustee is a beneficiary of the trust
  - If the trust is an express unitrust or is a unitrust by reason of a conversion
- Mississippi has added a safe harbor provision to the trustee's power to adjust. A Trustee may make a safe-harbor adjustment to increase net trust accounting income by an amount up to six percent (6%) of the trust's value. § 91-17-104(g)(1) provides, "If a trustee determines to make this safe-harbor adjustment, the propriety of this adjustment shall be conclusively presumed."
- Louisiana has a similar safe harbor provision for it's power to adjust. However,, the safe harbor limit is 5%. In addition, a trustee must get a court order for any adjustment in excess of 5%.

Trustee's Power to Adjust

- The key element in using the adjustment power is to determine the appropriate level or range of income for the income beneficiary. In Louisiana and Mississippi, the range is determined by statute.
- Once the trustee has determined the range of income, the trustee must determine whether and to what extent to exercise her adjustment power.
- A trustee should remember, however, that the adjustment power is an investment tool, not a technique to benefit one beneficiary over another.

TRUSTEE'S POWER TO ADJUST

- Example where a trustee may consider the adjustment power:
  - T is the trustee of a trust that requires the income to be paid to the settlor's son C for life, remainder to C's daughter D. The trust instrument explicitly grants to T the power to adjust between income and principal. In a period of very high inflation, T purchases bonds that pay double-digit interest and determines that a portion of the interest, which is generally allocated to income under the principal and income act, is a return of capital. In consideration of the loss of value of principal due to inflation and other factors that T deems relevant, T may transfer part of the interest to principal.
  - Note that if the trust instrument does not explicitly grant T the power to adjust between income and principal, T may not adjust.

Terminating Income Interest

- Complex trusts may have a number of income interests, either concurrent or successive, and the trust will not necessarily end when one of the income interests ends. For that reason, the Act speaks in terms of income interests ending and beginning rather than trusts ending and beginning.
- Alabama, Florida and Mississippi adopted the substantive provisions of section 201 of the Uniform Act, though Alabama reordered the order of the Section 201.
- Ala. Code Section 19-3A-201 describes how income is to be determined and distributed after an income interest in a trust ends.
- Under Ala. Code Section 19-3A-201(a), if an asset has been specifically devised to a beneficiary, the trustee pays net income and net principal receipts attributable to that property as determined under the Alabama principal and income act by:
  - including all amounts received or paid with respect to the property, whether due before, on or after the date that triggers the transfer (Ala. Code Section 19-3A-201(a)(1)); and
  - Not reducing disbursements from income or principal under Ala. Code Section 19-3A-501 Ala. Code Section 19-3A-502 if the trust or applicable law provides that such disbursements be made from another source or to the extent that the fiduciary recovers or expects to recover payment from a third party (Ala. Code Section 19-3A-201(a)(2))

Terminating Income Interest

- Ala. Code Section 19-3A-201(b) provides that the beneficiary of a pecuniary gift is entitled to as much interest provided under the trust or applicable law, to be paid first from net income (as determined under Ala. Code Section 201(2)) and, second, to the extent such net income is insufficient, from principal
- Under Ala. Code Section 19-3A-201(c), the trustee determines the remaining net income by applying the Articles 3 through 5 of the Alabama principal and income act, and then doing the following:
  - including in net income all income from property used to discharge liabilities
  - paying from either income or principal, in the fiduciary's discretion, professional fees (attorneys, accountants and fiduciaries), court costs, other administrative expenses and any interest on death taxes (but the fiduciary's discretion is limited in this regard, as discussed below)
  - paying from principal all other disbursements made in connection with either settling the estate or winding up the terminating income interest (including debts, funeral expenses, family allowances and death taxes and related penalties attributable to the estate or terminating interest under either the terms of the document or, if none, applicable law)

Terminating Income Interest

- Under Ala. Code Section 19-3A-201(d), the net income distributable to residuary or remainder beneficiaries is to be paid in accordance with the rules in Ala. Code Section 19-3A-202
- Mississippi adopted Section 202 of the Uniform Act in its entirety. Alabama and Florida, however, differ from the Uniform Act in that they both adopt methods of using inventory methods rather than market efforts in order to reduce the effects of market fluctuations during the period of administration to the income beneficiaries of pecuniary bequests in trusts and reduces the administrative burden on the fiduciary during administration.
- Ala. Code Section 19-3A-202 provides that each beneficiary is entitled to receive a portion of net income equal to the beneficiary's fractional interest in undistributed principal assets, using inventory values as of the date of distribution
- The specific rules governing this division of net income are set forth in Ala. Code Section 19-3A-202(b)
- Under Ala. Code Section 19-3A-202(c), the fiduciary must maintain appropriate records if the fiduciary does not distribute all income on a single distribution date

Apportionment at Beginning and End of Income Interest

- Alabama, Mississippi and Florida all adopted Article 3 of the Uniform Act with no real substantive changes
- Ala. Code Section 19-3A-301 defines when income interests begin and end, including when an asset becomes subject to trust
- Ala. Code Section 19-3A-302 provides defines the manner in which receipts and disbursements are made if the due date of such receipt or disbursement occurs before an income interest begins in the case of a trust:
- Ala. Code Section 19-3A-303 addresses the apportionment of “undistributed income,” which is income received before the date on which an income interest ends

Character of Receipts from Entities

- Alabama, Mississippi and Florida all adopted versions of Section 402 of the Uniform Act.
- Mississippi and Florida adopted with few substantive changes. Alabama, however, made some changes, specifically deleting the "20% of the entity's gross assets" bright line test for partial liquidations.
- Ala. Code Section 19-3A-401(b) provides that in general, money received from an entity is allocated to income. Ala. Code Section 19-3A-401(a) defines "entity" as a corporation, partnership, limited liability company, regulated investment company, real estate investment trust, common trust fund, or any other organization in which a fiduciary has an interest.
- Ala. Code Section 19-3A-401(c) provides exceptions to the general rule, and requires a trustee to allocate the following receipts from entities to principal:
    - property other than money, except in cases where the fiduciary has the choice to receive dividends or similar payment either in case or in the shares or similar ownership interests of the corporation or other business entity, in which case, the fiduciary shall allocate the receipts to income
    - money received in one or more distributions in exchange for part of all of the trustee's interest in the entity

CHARACTER OF RECEIPTS FROM ENTITIES

  - money received in total or partial liquidation of the entity
  - money received from an entity that is a regulated investment company or REIT if the money distributed is a capital gain dividend for federal income tax purposes.

- Ala. Code Sections 19-3A-401(d) and (e) provides special rules for money received in total or partial liquidation of the entity.
- Ala. Code Sections 19-3A-401(d) provides that money is received in partial liquidation to the extent that the entity, at or near the time of the distribution, indicates that it is a distribution in partial liquidation.
- Ala. Code Sections 19-3A-401(e) provides that a fiduciary may rely upon a statement made by an entity about the source or character of a distribution if the statement is made <u>at or near the time of distribution</u> by the entity's board of directors or other person or group of persons authorized to exercise powers to pay money or transfer property comparable to those of a corporation's board of directors.

Distributions from Trusts and Estates

- Alabama, Mississippi and Florida all adopted Section 402 of the Uniform Act with no substantive changes.
- Ala. Code Sections 19-3A-402 provides that a fiduciary shall allocate to income an amount received as a distribution of income from a trust or a decedent's estate in which the trust has an interest…and shall allocate to principal an amount received as a distribution of principal from such a trust or decedent's estate.
- The Trustee must consider three factors:
  - the character of the distribution as defined under the distributing trust
  - the character of the distribution as it is received by the recipient trust
  - the definition of the distribution under the principal and income act
- Where the terms of the distributing trust are in conflict with the terms of the recipient trust, the Trustee may have to obtain instructions from court to resolve the conflict between the terms of the two documents.

Business and Other Activities Conducted by Fiduciary

- Alabama, Mississippi and Florida all adopted Section 403 of the Uniform Act with no substantive changes.
- Ala. Code Sections 19-3A-403 allows a trustee who accounts separately for a business or other activity to determine the extent to which its net cash receipts must be retained for working capital, the acquisition or replacement of fixed assets, and other reasonably foreseeable needs of the business or activity.
- The section is intended to give greater flexibility to a fiduciary who operates a business or other activity in proprietorship form rather than in a wholly-owned corporation (or, where permitted by state law, a single-member limited liability company), and to facilitate the fiduciary's ability to decide the extent to which the net receipts from the activity should be allocated to income, just as the board of directors of a corporation owned entirely by the trust would decide the amount of the annual dividend to be paid to the trust.

Business and Other Activities Conducted by Fiduciary

- The trustee may conduct this separate accounting if the trustee determines that it is in the best interest of all the beneficiaries. If the trustee maintains a separate accounting, the trustee may also determine the extent to which the remaining net cash receipts are accounted for as principal or income in the trust's general accounting records. The trustee may maintain separate accounting records for these business transactions whether those assets are segregated from other trust assets.
- Ala. Code Sections 19-3A-403(c) provides the following list of activities for which a fiduciary may maintain separate accounting records:
  - Retail, manufacturing, service, and other traditional business activities
  - Farming
  - Raising and selling livestock and other animals
  - Managing rental properties
  - Extracting minerals and other natural resources
  - Timber Activities
  - Activities related to derivatives and options

PRINCIPAL RECEIPTS

- Alabama, Mississippi and Florida all adopted Section 404 of the Uniform Act with no substantive changes.
- Ala. Code Sections 19-3A-404 provides that the following receipts are allocated to principal:
  - To the extent not allocated to income under the Alabama principal and income act, assets received from a transferor during the transferor's lifetime, a decedent's estate, a trust with a terminating income interest, or a payer under a contract naming the trust or its fiduciary as beneficiary
  - Subject to any contrary rules in Ala. Code Section 19-3A-401 through Ala. Code Section 19-3A-415, money or other property received from the sale, exchange, liquidation, or change in form of a principal asset, including realized profit
  - Amounts recovered from third parties to reimburse the trust because of disbursements described in Ala. Code Section 19-3A-502(c) or for other reasons not based on the loss of income
  - Proceeds of property taken by eminent domain, but a separate award made for the loss of income with respect to an accounting period during which a current income beneficiary had a mandatory income interest is income
  - Net income received in an accounting period during which there is no beneficiary to whom a fiduciary may or must distribute income
  - Other receipts as provided in Ala. Code Section 19-3A-408 through Ala. Code Section 19-3A-408.

Rental Property

- Alabama, Mississippi and Florida all adopted Section 405 of the Uniform Act with no substantive changes.
- Receipts from rental property that are not separately accounted for under Ala. Code Sections 19-3A-403 are addressed by Ala. Code Sections 19-3A-405
- This section provides that the trustee shall allocate to income an amount received as rent of real or personal property, including an amount received for cancellation or renewal of a lease.
- However, amounts received as a refundable deposit, including security deposits or deposits to be applied as rent for future periods, must be added to principal and held subject to the terms of the lease

Bonds and other Obligations

- Mississippi adopted Section 406 of the Uniform Act with no real substantive changes. Florida and Alabama, however, made changes to Section 406.
- Ala. Code Sections 19-3A-406(a) provides amounts received as interest, whether determined at a fixed, variable, or floating rate, on a <u>bond</u> or an obligation to pay money to the fiduciary shall be allocated to income.
- Ala. Code Sections 19-3A-406(b) provides that generally, a fiduciary shall allocate to principal any gain or loss realized upon the sale or maturity of any bond or obligation to pay money to the fiduciary, regardless of how such bond or other obligation was acquired
- However, Ala. Code Sections 19-3A-406(c) provides that fiduciary shall allocate to income the difference between inventory value or cost, and the amount realized upon sale or maturity, if greater, for bonds or other obligations that do not bear interest, regardless of how or when such bond or other obligation was acquired
- In addition, Ala. Code Sections 19-3A-406(d) provides that for bonds or other obligations that are acquired by a fiduciary subsequent to the time the principal was established and whose cost is greater than their par or maturity value, the fiduciary shall amortize periodically out of income the premium paid, and upon sale or maturity, shall allocate to principal any gain or loss realized thereon

Insurance Policies and Similar Contracts

- Alabama, Mississippi and Florida all adopted Section 407 of the Uniform Act with no substantive changes.
- Ala. Code Sections 19-3A-407(a) provides that a trustee must allocate the proceeds of a life insurance policy or other contract in which the trust or trustee is the beneficiary to principal. This includes contracts insuring the trust against loss for damage to, destruction of or loss of title to a trust asset
- Ala. Code Sections 19-3A-407(a) also provides that a trustee must allocate dividends on an insurance policy to income if the premiums are paid from income and to principal if the premiums are paid from principal
- Ala. Code Sections 19-3A-407(b) provides an exception to the general rule; proceeds of a contract that insure the trustee against loss of occupancy or other use by an income beneficiary, loss of income or loss of profits from a business are allocated to income

Insubstantial Allocation not Required

- Mississippi and Florida adopted Section 407 of the Uniform Act with no substantive changes; however, Alabama made substantial deviations from the Uniform Act.
- Ala. Code Section 19-3A-407(a) provides that if a fiduciary determines that an allocation between principal and income required by Ala. Code Section 19-3A-409, Ala. Code Section 19-3A-410, Ala. Code Section 19-3A-411, Ala. Code Section 19-3A-412, or Ala. Code Section 19-3A-415 is insubstantial, then the fiduciary may allocate the entire amount to principal, unless one of the circumstances described in Ala. Code Section 19-3A-104(c) applies to the allocation
- The purpose of the section is to relieve a fiduciary from making relatively small allocations while preserving the fiduciary's right to do so if an allocation is large in terms of absolute dollars

Deferred Compensation, Annuities and Similar Payments

- Alabama and Mississippi adopted Section 409 of the Uniform Act with no substantive changes; however, Florida made substantial deviations from the Uniform Act.
- Ala. Code Section 19-3A-409(b) provides that to the extent that a payment or portion thereof is characterized by other sections of the Alabama principal and income act as income in the hands of the payer, a fiduciary shall allocate such payment or portion thereof to income. The fiduciary shall allocate to principal the balance of the payment and any other payment received in the same accounting period that is not characterized as income to the payer by other sections of the Alabama principal and income act
- Ala. Code Section 19-3A-409(c) provides that to the extent that no part of the payment is allocated between income and principal pursuant to Ala. Code Section 19-3A-409(b), a fiduciary shall allocate to income ten percent (10%) of the part that is required to be made during the accounting period and the balance to principal.
- Ala. Code Section 19-3A-409(c) further provides that if no part of a payment is required to be made or if the payment received by the fiduciary is the entire amount to which the fiduciary is entitled, then the fiduciary shall allocate the entire payment to principal. The section provides that a payment is not "required to be made" to the extent that it is made because the fiduciary exercises a right of withdrawal.

Deferred Compensation, Annuities and Similar Payments

- Ala. Code Section 19-3A-409(e) provides that Ala. Code Section 19-3A-409(f) and Ala. Code Section 19-3A-409(g) apply and Ala. Code Section 19-3A-409(b) and Ala. Code Section 19-3A-409(c) do not apply if and to the extent that the series of payments would, without the application of subsection (d), qualify for the marital deduction under Section 2056(b)(7)(C) of the Internal Revenue Code of 1986, as amended, 26 U.S.C. Section 2056(b)(7)(C), as amended
- Under Ala. Code Section 19-3A-409(f) the trustee determines the amount of income of each separate fund for an accounting period as if the separate fund were a trust subject to the Alabama principal and income act.
    - If the surviving spouse requests, the trustee must demand that the separate fund's administrator distribute the fund's internal income to the trust.
    - The trustee must allocate a payment from the separate fund to income to the extent of the fund's internal income and distributes that amount to the spouse.
    - The trustee must allocate the balance to principal.
    - If the surviving spouse requests, the trustee must allocate principal to income to the extent the separate fund's internal income exceeds payments made from the fund to the trust during the accounting period.

Deferred Compensation, Annuities and Similar Payments

- Under Ala. Code Section 19-3A-409(g), if a fiduciary cannot determine the internal income of a separate fund but can determine the value of the separate fund, the internal income of the separate fund for the accounting period is deemed to equal four percent of the fund's value, according to the most recent statement of value preceding the beginning of the accounting period.
- If the fiduciary can determine neither the internal income of the separate fund nor the fund's value, the internal income of the fund for the accounting period is deemed to equal the product of the interest rate and the present value of the expected future payments, as determined under Section 7520 of the Internal Revenue Code of 1986, as amended, 26 U.S.C. Section 7520, as amended, for the month preceding the accounting period for which the computation is made.

Liquidating Assets

- Alabama, Mississippi and Florida adopted Section 410 of the Uniform Act with few substantive changes.
- Under Ala. Code Section 19-3A-410(b), a fiduciary shall allocate ten percent of the receipts from a liquidating asset and the remaining balance to principal
- Ala. Code Section 19-3A-410(b) defines “liquidating asset” as an asset whose value will diminish or terminate because the asset is expected to produce receipts for a period of limited duration, and includes a leasehold, patent, copyright, royalty right, and right to receive payments under an arrangement that does not provide for the payment of interest on the unpaid balance
- The rule imposes on a trust the obligation to pay a fixed annuity to the income beneficiary until the asset is exhausted, and to add the balance of each year's receipts to principal

Minerals, Water and other Natural Resources

- Alabama, Mississippi and Florida adopted Section 411 of the Uniform Act with no substantive changes.
- Under Ala. Code Section 19-3A-411, as a general rule, 10% of receipts from an interest in minerals or other natural resources (other than timber) is allocated to income and 90% is allocated to principal. However, the section provides the following special treatment:
  - nominal delay rentals and nominal annual rent on a lease are allocated to income
  - production payment receipts are allocated to income to the extent that the agreement creating the production payment provides a factor for interest or its equivalent and the balance is allocated to principal
  - amounts received as royalty, shut-in-well payments, take-or-pay payments, bonus or delay rental are allocated 10% to income and 90% to principal if the payment is more than nominal.
- In addition, receipts from an interest in water is allocated to income if the water is renewable; otherwise, 90% of receipts is allocated to principal and the balance is allocated to income.

Timber

- Mississippi and Florida adopted Section 412 with few substantive changes; Alabama, however, greatly deviated from the Uniform Act.
- Ala. Code Section 19-3A-412 adopts an approach which seeks to recover and allocate to principal the amount received related to the volume of timber on the land at the time the timberland was transferred to the trust or the decedent's estate as follows:
  - the fiduciary shall allocate the net receipts first to principal, based upon the volume of the timber at the time of transfer to the trust or decedent's estate
  - the balance shall be allocated eighty percent (80%) to income and the balance to principal
- Under Ala. Code Section 19-3A-412(b), a fiduciary shall deduct the following expenses related to the sale of timber and related products from gross receipts:
  - management expenses
  - legal and accounting expenses and fees
  - sales commissions
  - reforestation expenses
  - any necessary timber stand improvement expense that is recognized and accepted as good forest management practice at the time of sale

Unproductive Property

- Alabama, Mississippi and Florida adopted Section 413 of the Uniform Act with few substantive changes.
- Ala. Code Section 19-3A-413(b) provides the general rule that proceeds from the sale or other disposition of an asset are principal without regard to the amount of income the asset produces during any accounting period.
- However, under Ala. Code Section 19-3A-413(a), in the case of property for which a marital deduction is allowed that does not provide the spouse with sufficient income from or use of the trust assets, the spouse may require the trustee to make property productive of income, convert property within a reasonable time or exercise the adjustment power under Ala. Code Section 19-3A-104

Derivative Instruments and Options

- Alabama, Mississippi and Florida adopted Section 414 of the Uniform Act with few substantive changes.
- Under Ala. Code Section 19-3A-414(b), to the extent that the trustee does not allocate receipts from derivatives under UPIA §403 (dealing with business and other activities conducted by the trustee), the trustee shall allocate receipts from and disbursements made in connection with derivative transactions to principal
- Ala. Code Section 19-3A-414(a) defines "derivative instrument" as a contract, a financial instrument, or a combination of contracts and financial instruments which gives a trust the right or obligation to participate in some or all changes in the price of a tangible or intangible asset or 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
- As to options, Ala. Code Section 19-3A-414 provides that if a trustee grants an option to buy property from the trust (whether the trustee owns the property when the option is granted), amounts received for granting the option must be allocated to principal. Any amounts paid to acquire options must be paid from principal. Finally, gain or loss realized upon the exercise of an option including an option granted to a settler of the trust for services rendered, also are allocated to principal

Asset Backed Securities

- Alabama, Mississippi and Florida adopted Section 415 of the Uniform Act with few substantive changes.
- Under Ala. Code Section 19-3A-415, the trustee allocates to income the portion of a payment from asset backed securities "which the payer identifies as being from interest or other current return" and allocates the balance of the payment to principal
- If the trustee receives one or more payments in exchange for the trust's entire interest in an asset-backed security in one accounting period, then the trustee allocates the payments to principal
- On the other hand, if the payment is one of a series of payments that results in the liquidation of the interest in the security over more than one accounting period, then the trustee allocates 10% of the payment to income and the balance to principal
- Ala. Code Section 19-3A-415 defines asset backed security as an asset whose value is based upon the right it gives the owner to receive distributions from the proceeds of financial assets that provide collateral for the security and includes an asset that gives the owner the right to receive from the collateral financial assets (1) only the interest or other current return thereon or (2) only the proceeds other than interest or current return

Disbursements from Income and Principal

- Alabama, Mississippi and Florida adopted Section 501 of the Uniform Act with few substantive changes.
- Under Ala. Code Section 19-3A-501, the trustee makes the following disbursements from income:
  - all of the regular compensation of the trustee and of any person providing investment advisory or custodial services to the trustee, to the extent not charged to principal pursuant to Ala. Code Section 19-3A-502(a)(1)
  - all expenses for accountings, judicial proceedings, or other matters that involve both the income and remainder interests, to the extent not charged to principal pursuant to Ala. Code Section 19-3A-502(a)(1)
  - all of the other ordinary expenses incurred in connection with the administration, management, or preservation of trust property and the distribution of income, including interest, ordinary repairs, regularly recurring taxes assessed against principal, and expenses of a proceeding or other matter that concerns primarily the income interest
  - All recurring premiums on insurance covering the loss of a principal asset or the loss of income from or use of the asset
  - All disbursements related to environmental matters, to the extent not charged to principal pursuant to Ala. Code Section 19-3A-502(c)

Disbursements from Income and Principal

- Mississippi and Florida adopted Section 502 of the Uniform Act with few substantive changes. Alabama, however, differs from Section 502 of the Uniform Act.
- Under Ala. Code Section 19-3A-502, the trustee makes the following disbursements from income:
  - an amount, not to exceed fifty percent (50%), of the disbursements described in Ala. Code Section 19-3A-501(a) and Ala. Code Section 19-3A-501(b)
  - all of the trustee's compensation calculated on principal as a fee for acceptance, distribution, or termination, and disbursements made to prepare property for sale
  - payments on the principal of a trust debt
  - expenses of a proceeding that concerns primarily principal, including a proceeding to construe the trust or to protect the trust or its property
  - premiums paid on a policy of insurance not described in Ala. Code Section 19-3A-501(d), of which the trust is the owner and beneficiary
  - estate, inheritance, and other transfer taxes, including penalties thereon, apportioned to the trust which carries the name of the estate
- A trustee may charge all disbursements related to environmental matters to principal or income, as provided by applicable law.

Adjustment for Depreciation and Taxes

- Alabama and Mississippi adopted Section 502 of the Uniform Act with no real substantive changes. Florida, however, made some changes.
- Ala. Code Section 19-3A-503 gives the trustee the power to transfer to principal a reasonable amount of cash receipts from a principal asset that is subject to depreciation, with the exception of amounts for depreciation attributable to real property used by a beneficiary as a residence, incurred during the administration of an estate or any other depreciation if the trustee is accounting under Ala. Code Section 19-3A-403 for the business for which the asset is being used
- Ala. Code Section 19-3A-504 deals with reimbursements from income to principal for expenses paid from principal, such as extraordinarily large repairs, capital improvements, and disbursements made to prepare property for rental
- Ala. Code Section 19-3A-505 and Ala. Code Section 19-3A-506 deal with income taxes and adjustments to be made between income and principal as a result of payment of those taxes, respectively

Conversion to Unitrust

- A Unitrust or Total Return Trust is a trust that provides that an income beneficiary receives a set percentage of the net asset value (NAV) of the trust determined annually and usually paid monthly rather than receiving the income from the trust
- The essence of the total return unitrust is directly tied to the recognition that the artificial distinction between investing for income versus growth of principal, as opposed to investing for total return, is frequently an unsuitable means of meeting the needs of income and remainder beneficiaries alike.
- The addition of the power to convert to a unitrust is intended to increase the trustee's ability to accomplish the purposes of the trust, without constraining the trustee's investment choices.

Conversion to Unitrust

- Alabama and Florida have adopted statutes to convert to unitrusts. Mississippi and Louisiana have not adopted similar legislation.
- Although not identical, Alabama's and Florida's statute allowing for conversions to unitrust share similar concepts:
  - Both states allow for nonjudicial conversions
  - Both states require prior notice and consent from beneficiaries
  - Both states require that the unitrust percentage be no more than 5% and no less than 3%

Conversion to Unitrust

- Ala. Code Section 19-3A-106(a) provides the requirements for a trustee to convert a trust into a unitrust as follows:
  - the Trustee must give written notice to qualified beneficiaries, disclosing the intent to convert and the effect of the conversion including the unitrust percentage to be used
  - there must be at least one of age income beneficiary and one of age remainder beneficiary
  - no qualified beneficiary, or person who may represent and bind a qualified beneficiary, objects to the conversion within sixty (60) days of the date of written notice of the conversion from the trustee
  - the conversion must not be expressly prohibited by the trust instrument

Conversion to Unitrust

- Ala. Code Section 19-3A-106(b) provides the requirements for a qualified beneficiary to convert a trust into a unitrust as follows:
  - the qualified beneficiary must give written notice to trustee, disclosing the intent to convert and the effect of the conversion including the unitrust percentage to be used
  - a representation by the qualified beneficiary that he/she/they have concluded that the conversion will enable the trustee to better carry out the intent of the settlor or testator and the purposes of the trust
  - the effective date of the conversion, which shall not be earlier than 60 days from the date of the written notice to trustee
  - the conversion must not be expressly prohibited by the trust instrument
  - if there is more than one qualified beneficiary, it must be signed by all whether directly or by representation
- Ala. Code Section 19-3A-106(b) allows the trustee or a qualified beneficiary to petition the court to review the conversion to a unitrust (even if timely objected to by qualified beneficiaries or opposed by the trustee); however, the must order the conversion if
  - the conversion will enable the trustee to better carry out the intent of the settlor and the purposes of the trust; or
  - all qualified beneficiaries have consented to the conversion

Conversion to Unitrust

- Ala. Code Section 19-3A-106(d) provides that the unitrust percentage shall not be less than three percent nor more than five percent
- Ala. Code Section 19-3A-106(i) prohibits conversion in the following circumstances:
  - If payment of the unitrust amount would change the aggregate annual amount payable to a beneficiary as a fixed annuity
  - If the trust is an “Institutional Fund” governed by the provisions of Ala. Code Section 19-3C-1, et seq
  - If the conversion would reduce any amount permanently set aside for charitable purposes under the governing instrument which is not expressed under the governing instrument as “income” or “net income” or determined pursuant to the terms of the governing instrument by reference to “income” or “net income”
  - If the conversion would reduce the value of any interest for which a federal estate or gift tax charitable deduction has been taken, or would cause the reduction of an amount being disbursed or to be disbursed to a charity for which an income, estate, or gift tax deduction has been taken
  - If possessing or exercising the power to convert would cause an individual to be treated as the owner of all or part of the trust for federal income tax purposes, and the individual would not be treated as the owner if the trustee did not possess the power to convert

Conversion to Unitrust

- Ala. Code Section 19-3A-106(i) prohibits conversion in the following circumstances:
  - If possessing or exercising the power to convert would cause all or part of the trust assets to be subject to federal estate or gift tax with respect to an individual, and the assets would not be subject to federal estate or gift tax with respect to the individual if the trustee did not possess the power to convert
  - If the conversion would result in the disallowance of a federal estate or gift tax marital or charitable deduction which would be allowed if the trustee did not have the power to convert

Thank You

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