WISCONSIN LEGISLATIVE COUNCIL

Terry C. Anderson, Director
Laura D. Rose, Deputy Director

TO: SENATOR GARY R. GEORGE

FROM: Ronald Sklansky, Senior Staff Attorney

RE: Senate Amendment __ (LRBa1396/1) to Senate Substitute Amendment __ (LRBs0341/1) to 2001 Senate Bill 109

DATE: March 5, 2002

This memorandum, prepared at your request, summarizes the provisions of Senate Amendment __ (LRBa1396/1) to Senate Substitute Amendment __ (LRBs0341/1) to 2001 Senate Bill 109.

1. Unitrusts

The senate amendment provides that a trust may be converted to a unitrust under certain conditions. A unitrust is a vehicle in which the allocation of income and principal is simplified by providing that a fixed percentage of the trust will be considered to be income. A trust may be converted by a trustee, either at his or her own discretion or at the request of a beneficiary, or by a court on the petition of a trustee or beneficiary. A trustee may undertake the conversion only if the conversion comports with the creator's intent and if all of the following apply:

a. The trustee determines that the conversion will enable the trustee to better carry out the purposes of the trust.

b. The trustee provides notice of the conversion and how the unitrust will operate.

c. There is at least one beneficiary who is eligible to receive income from the trust and at least one other beneficiary who would receive a distribution of principal if the trust were to terminate.

d. Every beneficiary consents to the conversion in writing.

e. The terms of the trust describe the amount that may or must be distributed by referring to the trust income.

f. The trustee invests and manages the trust assets under the prudent investor rule.

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A court may authorize the conversion of a trust to a unitrust on the petition of a trustee or a beneficiary, if all of the following apply:

a. The trustee or beneficiary has provided notice of the request and the notice advises how the unitrust will operate.

b. The court determines that the conversion will enable the trustee to better carry out the purposes of the trust.

A trustee of a unitrust must make distributions in accordance with the creating instrument, except that any reference in a creating instrument to "income" must be construed to mean a fixed percentage of the net fair market value of the unitrusts assets, regardless of whether the assets otherwise would be considered income or principal, averaged over the preceding three years or the period since the original trust was created, whichever is less. The fixed percentage will be determined by the trustee or by the court, as appropriate, but the fixed percentage determined by the trustee may not be less than 3% nor more than 5%.

After a trust is converted to a unitrust, a trustee may determine or change any of the following:

a. The frequency of distributions during the year.

b. Certain standards for proration of distributions.

c. The effect on the valuation of the unitrusts assets of other payments from, or contributions to, the unitrust.

d. How, and how frequently, to value the unitrusts assets.

e. Valuation dates.

f. Whether to omit from the valuation unitrust property occupied by or in the possession of a beneficiary.

g. Any other matters necessary for the proper functioning of the unitrust.

A court may do any of the following with respect to a unitrust on an appropriate petition:

a. Change the fixed percentage of the assets that will be determined to be income.

b. Provide for distributions of net income to preserve tax benefits.

c. Average the valuation of assets over a period other than that otherwise prescribed.

d. Require the unitrust to be converted back to the original trust under the creating instrument.

A trust may not be converted to a unitrust under defined conditions, including that the creating instrument specifically prohibits the conversion, that distributions will change the amount payable to a beneficiary as a fixed annuity or a fixed fraction of the value of the trust assets, that certain unfavorable

tax consequences occur, or that the trustee is a beneficiary of the trust. However, in the last circumstance, a co-trustee may convert the trust to a unitrust when the co-trustee is not a beneficiary.

The ability to convert to a unitrust applies only to a trust created under an instrument executed on or after the effective date of the act.

2. *LIMITS ON LIABILITY*

The senate amendment creates s. 701.20 (31) to provide that if a trustee sends to all beneficiaries a written communication relating to a trust, any action against the trustee that is based on the subject of the written communication must be commenced within two years after the trustee sends the written communication or be barred. However, this provision does not apply to an action based on fraud or misrepresentation with respect to the written communication.

RS:ksm;tlu

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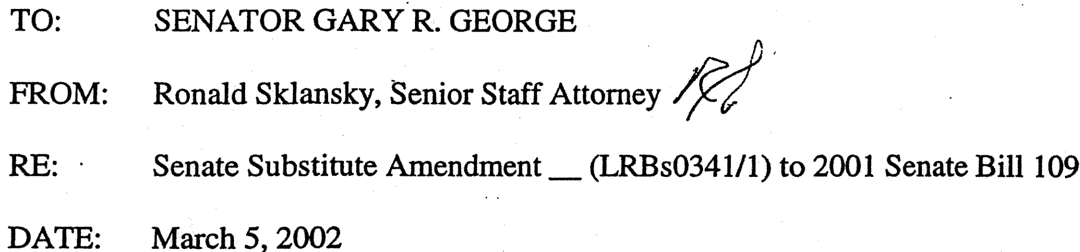

TO: SENATOR GARY R. GEORGE

FROM: Ronald Sklansky, Senior Staff Attorney

RE: Senate Substitute Amendment __ (LRBs0341/1) to 2001 Senate Bill 109

DATE: March 5, 2002

This memorandum, prepared at your request, summarizes the differences between Senate Bill 109, generally relating to the fiduciary relationship and allocations between principal and income for trusts and estates, and Senate Substitute Amendment __ (LRBs0341/1).

1. SCHOOL FUNDS

Senate Bill 109 provides that funds of a first class city school system held in certain pensions may be invested and reinvested in the same manner as is authorized for investments under the new prudent investor rule. [SECTION 6.] The substitute amendment deletes this provision since it has been enacted into law in 2001 Wisconsin Act 30.

2. UNIFORMITY

Senate Bill 109 creates s. 701.20, Stats., and states that the section may be cited as the Uniform Principal and Income Act. The proposed statute also states that in applying and construing the Act, consideration must be given to the need to promote uniformity among the states enacting it. [See proposed s. 701.20 (1) and (31), Stats.] The substitute amendment removes these provisions because additional amendments made in the substitute amendment make the provisions less uniform with other states' laws.

3. NOTICE TO BENEFICIARIES

The substitute amendment provides that a trustee may obtain approval of a trustee's adjustments between principal and income by providing a written notice to all sui juris beneficiaries at least 30 days before the proposed action is to take effect. A "sui juris beneficiary" is a beneficiary not under a legal disability, including a court-appointed guardian of an incapacitated beneficiary, an agent for an incompetent beneficiary, or a court-appointed guardian of a minor beneficiary's estate or, if there is no

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court-appointed guardian, the parents of the minor beneficiary. A trustee may decide not to implement a proposed action after a written objection is received. If a written objection is received, either the trustee or the beneficiary making the written objection may petition the court to have the proposed action approved, modified, or prohibited. [See proposed s. 701.20 (2) (km) and (4) (c), Stats.]

4. Determination and Distribution of Net Income

Senate Bill 109 provides that a fiduciary must distribute to a beneficiary who receives an outright pecuniary amount the interest or any other required amount from net income or from principal to the extent that net income is insufficient. The substitute amendment provides that a fiduciary must distribute to a beneficiary, including a trustee, who receives a pecuniary amount, not determined by a pecuniary formula, interest at the statutory legal rate on any unpaid portion of the pecuniary amount for the period commencing one year after the decedent's death or after the income interest in the trust ends. This interest must be distributed from net income or from principal to the extent net income is insufficient. [See proposed s. 701.20 (5) (c), Stats.]

Senate Bill 109 also provides that a fiduciary must distribute net income remaining after distributions to residuary and remainder beneficiaries, even if the beneficiary holds an unqualified power to withdraw assets from the trust or other presently exercisable general power of appointment over the trust. The substitute amendment deletes the proposed statutory language referring to a beneficiary who holds an unqualified power to withdraw assets from the trust or other presently exercisable general power of appointment over the trust. [See proposed s. 701.20 (5) (d), Stats.]

5. Distribution to Residuary and Remainder Beneficiaries

Senate Bill 109 provides that in determining a beneficiary's share of net income, one rule in this determination is that the beneficiary's fractional interest in the undistributed principal assets must be calculated without regard to property specifically given to a beneficiary and property required to pay pecuniary amounts not in trust. The substitute amendment applies the rule that the beneficiary's fractional interest in the undistributed principal assets must be calculated without regard to property specifically given to a beneficiary and property required to pay pecuniary amounts not ***determined by a pecuniary formula***. [See proposed s. 701.20 (6) (b) 2., Stats.]

6. Deferred Compensation, Annuities, and Similar Payments

Senate Bill 109 provides that when a trustee receives a payment from a separate fund created by a payer, including an annuity, an individual retirement account, and a pension, profit-sharing, stock-bonus, or stock-ownership plan, a trustee must allocate the payment to income to the extent that the payment is characterized as interest or a dividend or a payment made in lieu of payment of a dividend. The balance must be allocated to principal. If no part of a payment is characterized as interest, a dividend, or equivalent payment, and all or part of the payment is required to be made, a trustee must allocate to income 10% of the part that is required to be made during the accounting period and the balance to principal. If no part of the payment is required to be made, or the payment received is the entire amount to which the trustee is entitled, the trustee must allocate the entire payment to principal. [See proposed s. 701.20 (18) (c), Stats.]

The substitute amendment provides that, for each accounting period of a trust in which the trust receives a payment but no part of any payment is allocated to income, the trustee must allocate to income that portion of the aggregate value of all payments received by the trustee in the accounting period that is equal to the amount of plan income that is attributable to the trust's interest in the plan from which payment is received for that accounting period. [See proposed s. 701.20 (18) (c), Stats.]

7. Applicability

Senate Bill 109 provides that proposed s. 701.20 will apply to every trust or decedent's estate existing on the effective date of the bill and to every trust or decedent's estate created or coming into existence after that date, accept as otherwise expressly provided in proposed s. 701.20, Stats., or by the decedent's will or the terms of the trust. The substitute amendment clarifies that with respect to a trust or decedent's trust existing on the effective date of the bill, proposed s. 701.20, Stats., will not apply before the trust's or estate's first accounting period that begins after the law takes effect. [See proposed s. 701.24 (2), Stats.]

RS:tlu;ksm

UNITRUST SECTIONS

I. Add new § 701.20(2)(ka) as follows:

(ka) "Sui juris beneficiary" is a beneficiar
shall include:

1. a court appointed guardian of a

2. an agent for an incompetent be

3. a court-appointed guardian o
none, the parents of the minor beneficiary.

This is what the State Bar and the Bankers Assn. wants added to SB 109

II. Add new § 701.20(4a) as follows:

(4a) POWER TO CONVERT TO UNITRUST. (a) Conversion. – Unless expressly prohibited by the governing instrument, a trustee may release the power under sub. (4) (relating to the trustee's power to adjust) and convert a trust into a unitrust as described in this subsection if all of the following apply:

1. The trustee determines that the conversion will enable the trustee to better carry out the purposes of the trust.

2. The trustee gives written notice under sub. (4b) of the trustee's intention to release the power to adjust and to convert the trust into a unitrust and of how the unitrust will operate, including the payout percentage as described in par. (d)3. and what initial decisions the trustee will make under this subsection, including those described in par. (e).

3. There is at least one sui juris income beneficiary, either in an individual or representative capacity, under sub. (4b)(a)2.a. and at least one different sui juris remainder beneficiary, either in an individual or representative capacity, under sub. (4b)(a)2.b.

4. No sui juris beneficiary objects to the conversion to a unitrust in a writing delivered to the trustee within the period specified by the notice under sub. (4b).

(b) Judicially approved conversion. –

1. As an alternative to par. (a), the trustee may give written notice under sub. (4b) and petition the court to approve the conversion to a unitrust and the release of the power under sub. (4) whether or not any of the following apply:

a. A beneficiary timely objects to the conversion to a unitrust.

b. The requirement pertaining to sui juris beneficiaries under sub. (4a)(a)3. is met.

2. A beneficiary may request a trustee to convert to a unitrust. If the trustee does not convert, the beneficiary may give written notice under sub. (4b) and petition the court to order the conversion.

3. The court shall approve the conversion or direct the requested conversion if the court concludes that the conversion will enable the trustee to better carry out the purposes of the trust.

(c) Consideration. – The trustee shall apply sub. (4)(b) when deciding whether to exercise the power to convert to a unitrust under par. (a).

(d) Post conversion. – After a trust is converted to a unitrust, all of the following apply:

1. The trustee shall follow an investment policy seeking a total return for the investments held by the trust, whether the return is to be derived:

a. from appreciation of capital;

b. from earnings and distributions from capital; or

c. from both.

2. The trustee shall make regular distributions in accordance with the governing instrument construed in accordance with the provisions of this section.

3. The term "income" in the governing instrument shall mean an annual distribution (the "unitrust distribution") equal to the payout percentage stated in the trustee's written notice under sub. (4b)(a) or in a court order under par. (b)3. (the "payout percentage"), which shall equal a fixed percentage of the net fair market value of the trust's assets, whether such assets would be considered income or principal under other provisions of this section, averaged over the lesser of:

a. the three preceding years; or

b. the period during which the trust has been in existence; provided that, if the payout percentage is determined by the trustee by written notice under par. (a) or par. (d)4., the payout percentage shall not be less than 3% nor more than 5%.

4. The trustee may reconvert a trust from a unitrust or change the payout percentage under par. (d)3. or any of the determinations under par. (e). The

trustee shall reconvert the trust or make such other change after giving written notice as described in par. (a) or upon petition of and approval by the court as described in par. (b).

(e) Discretion of trustee. – The trustee may in the trustee's discretion from time to time determine all of the following:

1. The provisions for prorating a unitrust distribution for a short year in which a beneficiary's right to payments commences or ceases.

2. The frequency of unitrust distributions during the year.

3. The effect of other payments from or contributions to the trust on the trust's valuation.

4. Whether to value the trust's assets annually or more frequently.

5. What valuation dates to use.

6. How frequently to value nonliquid assets and whether to estimate their value.

7. Whether to omit from the calculations trust property occupied or possessed by a beneficiary.

8. Any other matters necessary for the proper functioning of the unitrust.

(f) Allocation. –

1. Expenses which would be deducted from income if the trust were not a unitrust may not be deducted from the unitrust distribution.

2. Unless otherwise provided by the governing instrument, the unitrust distribution shall be paid from net income, as such term would be determined if the trust were not a unitrust. To the extent net income is insufficient, the unitrust distribution shall be paid from net realized short-term capital gains. To the extent income and net realized short-term capital gains are insufficient, the unitrust distribution shall be paid from net realized long-term capital gains. To the extent income and net realized short-term and long-term capital gains are insufficient, the unitrust distribution shall be paid from the principal of the trust.

(g) Court orders. – The trustee or, if the trustee declines to do so, a beneficiary may petition the court to:

1. Select a payout percentage different from that stated in the trustee's written notice under par. (a) or in a prior court order under par. (b).

2. Provide for a distribution of net income, as would be determined if the trust were not a unitrust, in excess of the unitrust distribution if such distribution is necessary to preserve a tax benefit.

3. Average the valuation of the trust's net assets over a period other than that specified in par. (d)3.

4. Reconvert from a unitrust. Upon a reconversion, the power to adjust under sub. (4) shall be revived.

(h) Application. – Conversion to a unitrust does not affect a provision in the governing instrument directing or authorizing the trustee to distribute principal or authorizing a beneficiary to withdraw a portion or all of the principal.

(i) Prohibited conversions. – A trustee may not convert a trust into a unitrust in any of the following circumstances:

1. If payment of the unitrust distribution would change the amount payable to a beneficiary as a fixed annuity or a fixed fraction of the value of the trust assets.

2. If the unitrust distribution would be made from any amount which is permanently set aside for charitable purposes under the governing instrument and for which a Federal estate or gift tax deduction has been taken, unless both income and principal are so set aside.

3. If:

a. 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

b. the individual would not be treated as the owner if the trustee did not possess the power to convert.

4. If:

a. 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

b. 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.

5. If the conversion would result in the disallowance of a Federal estate tax or gift tax marital deduction which would be allowed if the trustee did not have the power to convert.

6. If the trustee is a beneficiary of the trust.

(j) Permissible conversion when otherwise prohibited. –

1. If par. (i)3., 4. or 6. applies to a trustee and there is more than one trustee, a co-trustee to whom the provision does not apply may convert the trust, unless the exercise of the power by the remaining trustee or trustees is prohibited by the governing instrument.

2. If par. (i)3., 4. or 6. applies to all the trustees, the trustees may petition the court to direct a conversion.

(k) Release of the power to convert. –

1. A trustee may release the power conferred by par. (a) to convert to a unitrust if any of the following apply:

a. The trustee is uncertain about whether possessing or exercising the power will cause a result described in par. (i)3., 4. or 5.

b. The trustee determines that possessing or exercising the power will or may deprive the trust of a tax benefit or impose a tax burden not described in par. (i).

2. The release may be permanent or for a specified period, including a period measured by the life of an individual.

NOTICE PROVISION

III. Add new § 701.20(4b) as follows:

(4b) NOTICE OF PROPOSED ACTION TO BENEFICIARIES. (a) A trustee may, but is not required to, obtain approval of a proposed action under sub. (4) by providing a written notice which complies with all of the following:

1. Notice of the proposed action must be given at least thirty (30) days before the proposed effective date of the proposed action. For purposes of this subsection, a proposed action includes a course of action or a decision not to take action under sub. (4) or (4a).

2. The notice must be given to all the sui juris beneficiaries who are:

a. income beneficiaries currently eligible to receive income from the trust; and

b. remainder beneficiaries who would receive, if no powers of appointment were exercised, a distribution of principal if the trust were to terminate immediately prior to the giving of notice.

3. The notice of proposed action must state that it is given pursuant to this subsection and must disclose the following information:

a. Identification of the trustee.

b. Description of the proposed action to be taken.

c. Time within which the beneficiaries may object to the proposed action, which shall be at least 30 days from the giving of the notice of proposed action. Notice shall be given as provided under Chapter 879.

d. The effective date of the proposed action if no objection under par. (d) is received.

4. The trustee is not required to give notice of a proposed action to any sui juris beneficiary who consents in writing to the proposed action. A sui juris beneficiary may give consent at any time before or after the proposed action it taken.

(b) A sui juris beneficiary may object to the proposed action by making a written objection to the trustee within the time period specified in the notice.

(c) A trustee may decide not to implement a proposed action after the trustee receives a written objection to the proposed action or for any other reason. In that event, the trustee shall give written notification to the sui juris beneficiaries of the decision not to take the proposed action.

(d) If a trustee receives a written objection to the proposed action within the time period specified in the notice, either the trustee or a beneficiary may petition the court to have the proposed action approved, modified or denied. In the court proceeding, the beneficiary objecting to the proposed action shall have the burden of proving that the trustee's proposed action should not be taken. A beneficiary who did not previously object to the proposed action is not estopped from opposing the proposed action in the court proceeding.

TRUSTEE LIABILITY

IV. Add new § 701.20(4c) as follows:

(4c) LIMITS ON TRUSTEE LIABILITY. The liability of a trustee for taking an action or for deciding not to take an action under sub. (4) or (4a) is limited as follows:

(a) Nothing in section 701.20 is intended to create or imply a duty on the part of the trustee to make an adjustment or convert to a unitrust under sub. (4) or (4a). A trustee shall not be liable for not considering whether to make an adjustment or convert to a unitrust or for choosing not to make an adjustment or convert to a unitrust under sub. (4) and (4a).

(b) In a proceeding with respect to a trustee's exercise or non-exercise of the power to make an adjustment or the power to convert to a unitrust under sub. (4) and (4a), the sole remedy is to direct, deny or revise an adjustment between principal and income or the conversion to a unitrust.

(c) A trustee is not liable to any income beneficiary or remainder beneficiary, his, her or its heirs or assigns, or to the trust for any action taken under sub. (4) or (4a) if the trustee gives written notice of the proposed action under sub. (4b) and the trustee does not receive a timely written objection to the notice.

(d) The trustee's decision not to implement a proposed action pursuant to sub. (4b)(c) shall not itself give rise to any liability on the part of the trustee.

V. Delete existing § 701.20(4m), JUDICIAL REVIEW OF DISCRETIONARY POWER.

INTEREST

VI. Replace § 701.20(5)(c) with the following:

(c) Unless the will or the terms of the trust otherwise provides, a beneficiary, including a trustee, of a pecuniary amount not determined by a pecuniary formula shall receive interest on any unpaid portion of the pecuniary amount for the period commencing one year after the decedent's death or after the income interest in the trust ends at the legal rate set forth in s.138.04. Such interest shall be distributed from net income determined under par. (b) or from principal to the extent that net income is insufficient.

VII. Modify § 701.20(5)(d) as follows:

(d) A fiduciary shall distribute the net income remaining after distributions required by par. (c) in the manner described in sub. (6) to all other beneficiaries, including a beneficiary who receives a pecuniary amount determined by a pecuniary formula.

VIII. Modify § 701.20(6)(b)2. as follows:

2. The beneficiary's fractional interest in the undistributed principal assets must be calculated without regard to property specifically given to a beneficiary and property required to pay pecuniary amounts not determined by a pecuniary formula.

RETIREMENT PLANS, IRAS, ETC.

IX. Replace § 701.20(18)(c) with the following:

(c) If no part of a payment is allocated to income pursuant to par. (b), then for each accounting period of the trust that any payment is received by the trust, the trustee shall allocate to income that portion of the aggregate value of all payments received by the trustee in that accounting period equal to the amount of plan income as defined herein attributable to the trust's interest in the plan for that accounting period. The trustee shall allocate the balance of that payment or payments to principal.

1. For purposes of this subsection, if a payment is received from a plan that maintains a separate account or fund for its participants or account holders, including, but not limited to, defined contribution retirement plans, individual retirement accounts, Roth individual retirement accounts, and some types of deferred compensation plans, the phrase "plan income" shall mean either the amount of the plan account or fund held for the benefit of the trust that, if the plan account or fund were a trust, would be allocated to income pursuant to the remaining provisions of this subsection for that accounting period, or four percent of the value of the plan account or fund on the first day of that accounting period. The method of determining plan income pursuant to this subsection shall be chosen by the trustee in the trustee's discretion. The trustee may change the method of determining plan income pursuant to this subsection for any future accounting period.

2. For purposes of this subsection if the payment is received from a plan that does not maintain a separate account or fund for its participants or account holders, including by way of example and not limitation defined benefit retirement plans and some types of deferred compensation plans, the term "plan income" shall mean four percent of the total present value of the trust's interest in the plan as of the first day of the accounting period, based on reasonable actuarial assumptions as determined by the trustee.

X. Modify § 701.20(18)(d) as follows:

(d) If, to obtain an estate or gift tax marital deduction for an interest in a trust, a trustee must allocate more of a payment to income than provided for by this subsection, the trustee shall allocate to income the additional amount necessary to obtain the marital deduction.

EFFECTIVE DATE

XI. Modify § 701.24(2) so that new § 701.20 will be effective on the first day of an existing estate's or trust's fiscal year beginning after enactment of Senate Bill 109.

National Conference of Commissioners on Uniform State Laws
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UNIFORM PRINCIPAL AND INCOME ACT (1997)
- A SUMMARY -

A trustee of a trust and the personal representative of a decedent's estate are called fiduciaries. They have special duties toward those who benefit from their administration. A trustee of a trust has a fiduciary obligation to satisfy both the interests of the trust's income beneficiaries during the life of the trust, and the interests of the remainder beneficiaries at the trust's termination. A personal representative may be required to allocate net income to certain individuals during the administration of the estate and to assure that certain expenses are paid out of an appropriate category of interests before finally distributing the assets of the decedent's estate to the heirs or devisees (heirs if there is no will, devisees if there is a will).

The trustee and the personal representative satisfy their obligations by making the proper allocations of assets to either principal or to income. Generally, assets allocated to principal serve the interests of remainder beneficiaries of a trust, and the interests of the final distributees of the assets in an estate. Assets allocated to income meet the requirements of income beneficiaries during the life of a trust, and those beneficiaries who must be paid out of the income derived during administration of an estate.

But the identification of principal and income, its allocation, and apportionment of assets between income and principal have always been a very tricky business. Distinguishing income from principal is not always self-evident. Therefore, the law has provided trustees with statutory help for a very long period of time. The Uniform Law Commissioners promulgated the first Uniform Principal and Income Act in 1931. A revision was promulgated in 1962. Almost all of the states in the United States have adopted one or the other of these earlier acts by 1997, when a new revision once again has been promulgated.

In 1997, 35 years after the 1962 revision, the Uniform Law Commissioners have promulgated the Uniform Principal and Income Act (1997) (UPIA 1997). Obsolescence over time is not the only stimulus for promulgating UPIA 1997. In the 1990's and especially since the promulgation of the Uniform Prudent Investor Act in 1994, a trustee's obligation to invest the assets of a trust as a prudent investor would invest them, has substantially altered the fiduciary obligations of a trustee. There is a strong relationship between the obligation to invest as a prudent investor and the obligation to satisfy income and remainder beneficiaries. The earlier Uniform Principal and Income Acts do not accommodate prudent investor rules. UPIA 1997 does, as will be discussed a little later in this summary.

UPIA 1997 provides some basic answers to questions that any trustee must ask in dealing with trust assets, and that personal representatives need to ask in the administration of an estate. The first question is whether an asset that becomes a trust or estate asset is either principal or

income? Once established as either principal or income, the next question is, when is a beneficiary entitled to receive that asset?

The answers to these questions are strongly affected by the time at which the question is asked. There are three relevant times to consider: the time before creation of an income interest, the time during which an income interest is current, and the time after the income interest ends (an income interest is merely the interest of the income beneficiary—the right to receive current payment). The time influences allocation of assets to principal or to income, and ultimately the rights of income and remainder beneficiaries.

The beginning and the end of the income interest are key, because 1) sometimes assets that would otherwise be income are allocated to principal if there is no current income interest; and 2) even if assets are allocated to income, when there is no current income interest, remainder beneficiaries will be entitled to a share of that income.

INITIAL RULE

The express language of the trust instrument, will, or other applicable document will govern, notwithstanding conflict with any statutory rule. UPIA 1997 is entirely a default statute that operates only when the governing instrument is silent.

ALLOCATION TO PRINCIPAL OR INCOME

Principal is fundamentally defined as the property held in trust for distribution to a remainder beneficiary when the trust terminates. Income is the current return that any fiduciary receives from an asset that is principal. It has never been sufficient to provide a bare general definition in any of the Uniform Principal and Income Acts. There is, therefore, a group of rules that establish what is principal and what is income with respect to specific kinds of assets.

UPIA 1997 refines old rules and provides specific rules for assets that are not accounted for in the earlier acts. An example of the refinement of old rules concerns receipts from an entity. The earlier uniform acts provide for corporate distributions, generally allocating ordinary dividends to income and any other distribution in the form of additional equity to principal. UPIA 1997 addresses the broader category of receipts from an "entity." A corporation is an entity, but so is a partnership, a limited liability company, a regulated investment company and a real estate investment trust. UPIA 1997 allocates the receipts from all entities in the same manner.

UPIA 1997 then simplifies the allocation question. Any "money" received by a fiduciary is regarded as income, unless it fits certain categories. For example, if money is received as part of a liquidation of the entity, it is principal. If money is received from an investment company (mutual fund) that labels a distribution as capital gain, the receipt is principal. All property received that is not money, i.e., a stock distribution, is principal. In addition, UPIA 1997

establishes what qualifies as a partial or complete liquidation of an entity. Fiduciaries will, thus, be better able to make judgments about receipts that are part of a liquidation. This is a more precise and logical set of rules for making allocations than exists in the earlier uniform acts, making fiduciaries' decisions easier and more certain.

There are certain kinds of assets that UPIA 1997 provides for that are just not within the scope of consideration in the earlier acts. One of them is derivatives. Another is asset-based securities. Receipts from derivatives, unless a trustee exercises powers available in the conduct of a business held in trust, are principal. Receipts from asset-based securities are either income or principal, depending upon the categorization of the asset backed security's payor.

APPORTIONMENT ISSUES

The beginning point and the ending point of an income interest in an estate or a trust provide particular problems, even though the incoming assets would clearly be income under the rules applied during the life of the income interest. Depending upon the time of receipt, an asset that is otherwise classified as income may have to be apportioned at least in part to principal to balance beneficiary interests. UPIA 1997 more precisely and simply provides for that apportionment than the earlier acts did.

UPIA 1997 provides, generally, that an income receipt is principal if it is due before a decedent dies in the case of an estate or before an income interest begins in the case of a trust. After death or after an income interest begins, it is classified as income. If there is income that is not distributed at the time the income interest ends, generally it is paid to income beneficiaries. But if the trust is revocable by an income beneficiary at an amount more than five percent of the trust's corpus immediately before the income interest ends, the undistributed income allocable to the revocable part, must be added to principal.

RIGHT TO PAYMENT

UPIA 1997 expressly requires distribution of net income and principal receipts to the appropriate beneficiaries when a decedent dies or when an income interest ends. There is discretion given to pay certain expenses out of either principal or income unless there is an adverse effect on estate tax marital deductions or income tax charitable deductions. General expenses of an estate are paid from principal. A specific pecuniary amount required to be paid, is paid from income unless insufficient. The deficiency is paid from principal. If there is any net income after the fact, it is distributed to remainder beneficiaries according to share in principal.

These rules assure orderly distribution of income when the decedent dies or an income interest ends. The earlier uniform acts make no attempt to deal with this distribution problem.

ADJUSTMENT POWERS

For Prudent Investment

A trustee must use prudent investment rules in any state that has adopted the Uniform Prudent Investor Act or equivalent statute, and in any case governed by the Restatement of the Law of Trusts III. The investment policy governing a trust's assets depends upon making the appropriate risk/return analysis and investing accordingly. Asset growth can be as significant an objective as income in setting the investment policy for a specific trust. Because a trustee may weight either growth or income significantly in making investment decisions, and because either may be greater or less than anticipated, the trustee may have to rebalance the interests of remainder and income beneficiaries as a result.

UPIA 1997 allows the trustee to adjust principal and income to the extent made necessary by prudent investment when a trust provides for a fixed income for the income beneficiary. This must be a careful decision before which "a trustee shall consider all of the factors relevant to the trust and its beneficiaries." The express list of factors includes "the nature, purpose, and expected duration of the trust;" and "the intent of the settlor." This is not a decision to be taken lightly—the list of express factors to consider is long. Adjustments are forbidden in certain circumstances, such as when they diminish "the income interest in a trust that requires all of the income to be paid at least annually to a surviving spouse and for which an estate tax or gift tax marital deduction would be allowed..." or "if the trustee is a beneficiary of the trust..." This list of forbidden situations, also, must be read with some care before a trustee decides to adjust allocations.

The earlier Uniform Acts did not deal with adjustment as a result of prudent investment. The whole notion of prudent investment, modern portfolio theory and total return came later than either of the two earlier acts. UPIA 1997 is absolutely necessary to making prudent investment work to its full capacity.

For Disbursements during the Administration of a Trust

Expenses and taxes must be paid during the administration of a trust. From which side of the ledger are they to be paid? Generally, UPIA 1997 provides for payment of ordinary expenses out of income, for payment of compensation to the trustee and legal proceedings from principal and income, dividing expenses in two, and payment of expenses peculiar to the remainder interest to principal. A trustee may transfer income to principal to make up for depreciation of an asset or to reimburse principal for disbursements that enhance income, i.e., repairs to assets that are necessary to maintain income. A trustee may make adjustments to principal and income to offset "shifting of economic interests or tax benefits between income and remainder beneficiaries" in certain instances.

During the Conduct of a Business Held in Trust

Under UPIA 1997, a trustee who conducts a business held in a trust may separate out the accounting for the business from that for other trust assets. The trustee, also, has the power to allocate net cash receipts to "working capital, the acquisition or replacement of fixed assets, and other reasonably foreseeable needs of the business or activity, and the extent to which the remaining net cash receipts are accounted for as principal or income in the trust's general accounting records."

The earlier uniform acts treated net profit from a business as income, and losses as principal. There is no flexibility.

For Tax Purposes

UPIA 1997 allows a fiduciary to make adjustments between principal and income for tax purposes. Tax liabilities may accrue to either income or remainder beneficiaries. A fiduciary may have to make elections under the tax laws. Imbalances of interests that arise because of taxes can be remedied by the fiduciary.

The earlier uniform acts did not provide such discretion to the fiduciary.

CONCLUSION

It is essential for the drafting and administration of wills and trusts that UPIA 1997 be adopted in every state and jurisdiction as soon as possible. Drafting of instruments becomes considerably harder without a modern set of rules that, among other things, allows adjustment because of prudent investment decisions and because of tax laws. If an instrument is not adequately drafted, trustees will not be able to meet fiduciary obligations. The result will be, higher costs for setting up trusts, more conflict between trustees and beneficiaries and excessive litigation. UPIA 1997 will make life much easier for personal representatives, trustees and beneficiaries alike.

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UNIFORM COMMERCIAL CODE
REVISED ARTICLE 5. LETTERS OF CREDIT

-A SUMMARY-

A "letter of credit" is an instrument that participates in the payment system along with drafts, checks, electronic fund transfers, and money. But it expresses a unique creditor-debtor relationship that distinguishes it from the other methods of payment that are codified under the Uniform Commercial Code, and has distinct uses in the extension of credit not shared with other kinds of payment. It is specifically defined in Revised Article 5 as an undertaking by an "issuer" of the credit to a "beneficiary," the individual who gets paid, on behalf of an "applicant," the individual to whom credit is extended by the "issuer." As defined, payment requires the presentation of a document, usually a draft on behalf of the beneficiary to the issuer.

Commonly, the issuer is (but not necessarily) a bank or similar financial institution. Commonly, the applicant is a customer of that bank, and the beneficiary is somebody with whom the applicant is doing business and who wants assurance that he or she will be paid.

A typical example of a letter of credit involves an American company intending to buy goods from a European manufacturer. The European manufacturer is willing to do business providing that it has assurances of payment for the goods that are to be purchased. The American company applies to its bank, with which it has accounts and lines of credit, for a letter of credit. The bank issues a document that is in actual letter form. In that letter it guarantees to the manufacturer that it will pay money up to a certain amount, upon receipt of an appropriate document, usually a draft, on behalf of the manufacturer. The letter contains any other documentary conditions agreed upon.

The applicant then takes the letter to the manufacturer while negotiating the purchase of the goods. The letter provides guarantee of payment, facilitating the transaction. At the appropriate time in the transaction, the manufacturer is paid upon presentation of the draft to the bank. Then the bank debits the appropriate account of the American company or establishes whatever creditor-debtor relationship is contemplated between it and the American company. Ultimately the bank is paid.

It is possible that there will be other parties to the transaction recognized by law. There may be a "confirmer" on the letter. The confirmer may be another institution or individual obligated to pay on the letter when the appropriate document is presented by the beneficiary. In the example, to facilitate payment, the American bank engages a European bank as a confirmer so the foreign manufacturer will actually present the required draft for payment to the foreign bank. A confirmer is always liable on a letter of credit.

There may also be an "advisor" on a letter of credit. The advisor is a third party who facilitates the transaction by advising the beneficiary either directly or through another advisor that the letter of credit has been issued, confirmed, or amended. Institutions or individuals acting as advisors give beneficiaries an added assurance that a letter of credit is valid. In the example, the American bank can employ the services of another foreign bank to notify the foreign manufacturer that the letter of credit has been issued in the name of the manufacturer. An advisor does not have direct liability on the letter of credit.

The letter of credit is of particular importance in international trade. With different payment systems in different countries, different laws governing fundamental transactions, business deals that must be transacted between strangers who are domiciled in different countries and who speak different languages, the letter of credit has become a common and accepted method of guaranteeing and obtaining payment. The foreign company has the comfort of the credit of the large, well-known financial institution when doing business with the domestic company.

The expansion of foreign trade is partly responsible for the large increase in the use of letters of credit in the United States. But there are other factors that have increased the use. Letters of credit generally are either ordinary commercial credits or standby letters of credit. The transaction used to illustrate typical use above involves an ordinary commercial credit. Standby letters of credit are used to back-up other primary creditor-debtor relationships, and in that sense are widely used in financing real estate development. What kind of large increase in use has occurred in the United States? In 1950 there were an estimated one-half billion dollars in outstanding credits. In 1989, the figure was $200 billion. Thus the need to revise Uniform Commercial Code Article 5 - Letters of Credit. That job is now complete.

The basic scheme of Article 5 does not change in the revision. The drafters' original intent was to provide a theoretical framework which would accommodate business practices however they would evolve. Original Article 5 defines the letter of credit and key terms, sets rules for establishing a letter of credit, provides some very basic rules prescribing the obligations of parties to a letter, including the obligations of confirmers and advisors, and establishes basic remedies for breach of these obligations. Revised Article 5 continues these objectives.

But Revised Article 5 leaves larger room for the evolution of business practices. Revised Article 5 does not change this basic orientation of the original drafters, except it considerably simplifies the rules.

For example, original Article 5 has rules for "notation credits" which are defined as credits that are payable only upon a notation of the amount of the payment on the actual letter. Honor of the draft or demand for payment requires the notation. This concept is not continued in Revised Article 5. It is one of those formal requirements with legal effect that results in dishonor of otherwise perfectly presented drafts or documents, impeding legitimate transactions.

Original Article 5 permits beneficiaries to use portions of a credit unless otherwise specified. Revised Article 5 simply leaves the issue to existing standards of practice. This is another example of simplification in the Revised Article 5

The primary reason for such simplifications is the specific inclusion of standards of practice in Revised Article 5. It provides that "An issuer shall observe standard practice of financial institutions that regularly issue letters of credit. Determination of the issuer's observance of that standard practice is a matter of interpretation for the court." The original Article 5 assumes that standards of practice are assumable as a matter of contract between the parties to a letter of credit. In Revised Article 5, the standards apply unless the contract otherwise specifies.

Standards of practice for letters of credit are very well formalized. First and foremost are the Uniform Customs and Practices for Documentary Credits (UCP), I.C.C. Publication No. 500, which are promulgated by the International Chamber of Commerce. The UCP is updated on a decadal basis, and is much relied upon in international trade as a common language of letter of credit transactions. The simplification in revised Article 5 suggests a clear recognition of the UCP as the source for many of the formal requirements and details of letters of credit. This permits business practices to govern the evolution of letters of credit within the aforementioned basic framework that Article 5 intends to provide.

Since almost the entirety of Article 5 in revised or original form is variable by agreement, specific provisions of the UCP may also become part of the agreement between the parties, or its provisions may be waived by agreement as well.
Between the expanded reliance upon existing standards of business practices as a default rule in Revised Article 5 and the ordinary ability to vary the default rules in Revised Article 5, people and institutions are given maximum flexibility in the tailoring of their relationships under letters of credit.

The standard of practice provision in Revised Article 5 is undoubtedly the most significant part of these revisions. There are some other significant changes, however.

One of the stated purposes for these revisions is to update Article 5 for the age of electronic communications. (This is an important objective with almost all the revisions and amendments to the Uniform Commercial Code in the decades of the 1980s and 1990s.) Original Article 5's statute of fraud requirements - calling for writings for enforcement - are abolished. Under Revised Article 5, "A letter of credit, confirmation, advice, transfer, amendment, or cancellation may be issued in any form that is a record and is authenticated (i) by a signature or (ii) in accordance with the agreement of the parties or the standard practice . . ."

The way to interpret this language is, simply, to say that a written document is no longer absolutely necessary to establish the existence of a valid letter of credit or of any other associated obligation. All that is required is an authenticated "record." A properly preserved computer record will suffice.

Another of the important changes concerns fraud and forgery in presentation for payment. As noted above, a letter of credit requires the presentation of a document, commonly a draft, for payment. What if the draft is fraudulent in some aspect or is forged? What is the issuer required to do? In certain instances under original Article 5, the issuer is required to honor such a draft, and in other cases may honor the draft. The issuer is not required under original Article 5 to police the process by which payment is obtained. However, in those situations in which the issuer has the discretion to honor the draft, the customer may petition the appropriate court to enjoin honoring the draft.

Original Article 5 uses the terminology of fraud in the transaction, and provides no guidelines with respect to which a court may consider the level of fraud that triggers the issuance of an injunction. In Revised Article 5, the terminology of fraud in the transaction is eliminated. A fraud that affects an injunction must be a "material" fraud. Further, Revised Article 5 establishes standards that the court must apply in determining whether to enjoin the issuer from honoring the draft. Included are factors of prohibition of injunction by other law, adverse effect upon the beneficiary, and availability of a remedy for fraud or forgery against the responsible individual or institution.

The remedies against an issuer for wrongful repudiation or dishonor of a letter of credit become more consistent under Revised Article 5 for letter of credit transactions. An issuer is bound to honor a proper documentary presentation. Repudiation occurs when the issuer communicates that a presentation will not be honored. A dishonor occurs when the issuer does not pay when the appropriate document is presented. Like any other legal obligation, the issuer is liable for wrongful repudiation or dishonor.

In original Article 5, the injured party can obtain the amount of the dishonored document plus incidental damages less the amount realized on the underlying transaction. If goods or documents of value as a result of the transaction are not sold to cover the losses, the issuer is entitled to them upon payment of judgment.

In Revised Article 5, the beneficiary or appropriate nominee is entitled to "the amount that is the subject of the dishonor or repudiation." If the obligation is not for payment of money, the injured party may have specific performance in lieu of damages, at the option of the injured person. Incidental damages are allowed, but not consequential damages. There is no obligation to cover the losses. If there is cover, the savings must be deducted from the recovered damages.

The applicant has a remedy for damages "resulting from breach," including incidental but not consequential damages. A breach by a confirmer or advisor gives rise to actual damages plus incidentals. Interest is due for any damages from the date of breach or dishonor. The prevailing party has a right to attorney's fees. There is a specific authority for prior agreement to liquidate damages. These provisions vastly improve and make more specific, the remedies available under Article 5.

A subject not specifically addressed in original Article 5 is the subject of subrogation of one party to another party to a letter of credit, upon payment of the other party's obligations. Subrogation rights are available by contract under original Article 5. The courts have not agreed upon their availability, otherwise, giving rise to confusion in the law.

Revised Article 5 provides specific rules. For example, if the issuer pays the beneficiary, the issuer is subrogated to the rights of the beneficiary and the applicant to the same extent as if the issuer were a secondary obligor of the underlying obligation. Subrogation rights do not arise until there has been an actual payment to the party whose rights are subrogated.

Subrogation puts the person with the subrogation right in the shoes of the person who benefitted by the payment that triggers the subrogation right. Subrogation rights balance equities between parties in complex transactions like letters of credit. Revised Article 5 solves the judicial quandary under original Article 5 as to whether automatic rights of subrogation exist.

It is not possible to list entirely in a short summary all of the problems under original Article 5 that are solved in Revised Article 5. For example, it was not clear under original Article 5 whether a letter of credit had to be a documentary letter of credit. It is not entirely clear under original Article 5 that a letter of credit is different from a guarantee. Revised Article 5 erases these ambiguities.

Letters of credit are an important part of the credit granting and payment system, and the commercial law. Revised Article 5 should carry letters of credit into the 21st Century with the clarity and flexibility necessary for successful governance of letter of credit transactions. All states should act to adopt these important revisions as soon as possible.

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By U.S. Mail and Electronic Mail

June 4, 2001

Honorable Gary George
State Capitol
P.O. Box 7882
Madison, WI 53707

Re: Senate Bill 109

Dear Senator George:

The Financial Planning Association ("FPA")[1] would like to offer our support for Wisconsin Senate Bill 109 which incorporates the language from the Uniform Prudent Investor Act as promulgated by the Uniform Law Commissioners in 1994. To date, trustees off trusts and like fiduciaries have been subject to rules that severely limit investments of trust assets. The Uniform Prudent Investor Act (the "Act") removes many of the outdated common law restrictions upon the investment authority of trustees of trusts and like fiduciaries. The Act provides rules governing investment that should result in greater protection for a trust's assets while providing a prospect for improved income.

The FPA has spent a considerable amount of time at both the national and local level scrutinizing and discussing the Uniform Prudent Investor Act and the Uniform Trust Code ("UTC") and we believe that both of these uniform acts would benefit consumers and professionals in the financial services profession. The UTC provides a comprehensive model for codifying the law on trusts and it includes and incorporates the provisions of the UPIA. The FPA supports the passage of legislation incorporating both of these uniform acts.

FPA appreciates your efforts on behalf of Wisconsin citizens and we urge you to support

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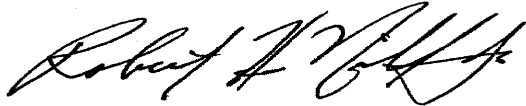
1 The Financial Planning Association is the largest organization in the United States representing financial planners and affiliated firms. FPA is domiciled in Washington, D.C., with administrative offices in Atlanta and Denver, and represents approximately 29,000 financial planners in the United States.

Senate Bill 109 which will be an invaluable tool for financial planners and their clients as they consider their financial options. We look forward to working with you to inform the Wisconsin legislature about the benefits of the UPIA. Please feel free to contact the undersigned if you have any questions or concerns about these comments.

Sincerely,



Robert H. Neill, Jr.
Legislative Counsel

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UNIFORM COMMERCIAL CODE
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-A SUMMARY-

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The expansion of foreign trade is partly responsible for the large increase in the use of letters of credit in the United States. But there are other factors that have increased the use. Letters of credit generally are either ordinary commercial credits or standby letters of credit. The transaction used to illustrate typical use above involves an ordinary commercial credit. Standby letters of credit are used to back-up other primary creditor-debtor relationships, and in that sense are widely used in financing real estate development. What kind of large increase in use has occurred in the United States? In 1950 there were an estimated one-half billion dollars in outstanding credits. In 1989, the figure was $200 billion. Thus the need to revise Uniform Commercial Code Article 5 - Letters of Credit. That job is now complete.

The basic scheme of Article 5 does not change in the revision. The drafters' original intent was to provide a theoretical framework which would accommodate business practices however they would evolve. Original Article 5 defines the letter of credit and key terms, sets rules for establishing a letter of credit, provides some very basic rules prescribing the obligations of parties to a letter, including the obligations of confirmers and advisors, and establishes basic remedies for breach of these obligations. Revised Article 5 continues these objectives.

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