HOUSE BILL REPORT
SSB 6267

As Reported by House Committee On:
Judiciary

Title: An act relating to the principal and income act.

Brief Description: Revising the principal and income act.

Sponsors: Senate Committee on Judiciary (originally sponsored by Senators Johnson and Kline).

Brief History:
Committee Activity:
Judiciary: 2/28/02 [DPA].

Brief Summary of Substitute Bill
(As Amended by House Committee)

- Updates, clarifies, and provides new rules for the treatment of trust property under the Washington Principal and Income Act.
- Sets rules for the distribution of estate income earned during probate as among trusts and other persons who are to receive property from the estate.
- Sets rules for allocating property in a trust between income beneficiaries and remainder beneficiaries when an income interest in the trust begins.
- Sets rules for the distribution and allocation of trust receipts and disbursements between principal and income.

HOUSE COMMITTEE ON JUDICIARY

Majority Report: Do pass as amended. Signed by 9 members: Representatives Lantz, Chair; Hurst, Vice Chair; Carrell, Ranking Minority Member; Boldt, Dickerson, Esser, Jarrett, Lovick and Lysen.

Staff: Bill Perry (786-7123).

Background:

A trust may create two kinds of beneficiaries. Income beneficiaries are persons who are entitled to earnings of the trust during some period of time. Remainder beneficiaries are persons who are entitled to the principal of the trust at the end of the period of the income beneficiaries' right to income.

A typical illustration of these two kinds of beneficiaries might be the surviving spouse and the children of a person who creates a trust. The person may put property in a trust with the income of the trust to go to his or her surviving spouse for the surviving spouse's lifetime, after which the remainder of the trust is to go to the children. The surviving spouse is the income beneficiary of the trust during his or her lifetime, and the children are the remainder beneficiaries.

A trustee of such a trust has a fiduciary duty to both kinds of beneficiaries. If a trust has two or more beneficiaries, the fiduciary is to act impartially among them and is to take into account the differing interests of the beneficiaries. Under the state's Investment of Trust Funds Act, a fiduciary is charged with using a "total asset management approach" in considering the impact of a possible investment of trust property on the "overall portfolio of assets."

The current Principal and Income Act is based on a 1971 uniform act and has rules about allocating the receipts and disbursements of a trust. The act generally acts as a default set of rules that apply unless the terms of the trust itself require otherwise. Some commentators have noted the tension and uncertainty that may be created for trustees when the rules of the Principal and Income Act are compared to the "total asset management" approach of the more modern Investment of Trust Funds Act. For instance, a trust portfolio investment decision by a trustee might be prudent regarding the trust as a whole, but might also significantly shift the balance of the trust with respect to the interests of income beneficiaries and remainder beneficiaries. Under the current Principal and Income Act, there is little discretion for a trustee to make such an investment and then to readjust the mix of the portfolio as between principal and income beneficiaries' interests.

The Washington State Bar Association is recommending the adoption of a new Washington Principal and Income Act based largely on the 1997 Uniform Principal and Income Act.

Summary of Amended Bill:

A new Washington Principal and Income Act is adopted. The act generally modernizes and updates the law regarding a trustee's authority and obligations in dealing with the interests of principal and income beneficiaries under a trust. The act also adopts the total asset management approach of the Investment of Trust Funds Act and gives trustees express authority to adjust allocations to principal and income in conjunction with managing investments.

The act contains Articles dealing with, among other things, the following subjects:

Fiduciary Duties and Powers.
Among the powers given trustees, is the power to adjust between principal and income. A fiduciary, whether a trustee or the personal representative of an estate with nonintervention powers, is authorized to make adjustments between principal and income of a trust or estate under certain conditions.

Adjustments may be made as considered necessary by a trustee so long as the trustee manages and invests trust assets as would a prudent investor, and the trust itself describes as "income" the amount from the trust that is to be distributed to a beneficiary, and after trying to meet the normal requirements of the act, the trustee is unable to achieve impartiality between beneficiaries.

Adjustments may not be made in certain circumstances, including the following, if the adjustment would: disallow a spouse's estate or gift tax marital deduction; diminish an intended gift tax exclusion; change the amount of a fixed annuity; come from certain amounts permanently set aside for charity; cause an individual to be treated as an owner of the trust for income tax purposes, or cause an asset to be included for estate tax purposes; or, if the trustee is a beneficiary or would benefit from the adjustment.

Decedent's Estate or Terminating Income Interest.
Rules are set out regarding the determination of income that has not yet been received from property in an estate, or from an income interest in a trust, after death of the estate holder or the end of the income interest.

Apportionment Between Principal and Income When an Income Interest Begins or Ends.
Rules are provided regarding when a right to an income interest begins under a trust. Generally, such a right begins on the date specified in the trust, or, if no date is specified, on the date an asset becomes subject to the trust. Specific rules are provided for determining when an asset becomes subject to a trust. Specific rules are provided for allocating a receipt or disbursement as between principal and income.

Allocation of Receipts During the Administration of a Trust.
Specific rules are provided for allocating receipts of the trust depending on the character of the receipt and the source of the receipt.

Special rules are also provided for kinds of receipts that are not to be apportioned between principal and income. For instance, generally, assets not otherwise allocated to income that are received from a transferor, estate, or other trust, are to be allocated to principal. On the other hand, for instance, rent on real property of a trust is to be allocated to income, but a refundable deposit must be applied to principal.

Some receipts, such as those from deferred compensation plans, annuities, liquidating assets, natural resource assets such as minerals, water or timber, are to be apportioned between income and principal based on specified rules.

Allocation of Disbursements During the Administration of a Trust.
Disbursements of a trust that are generally to be made half from income and half from principal include the trustee's regular compensation and trust accounting and judicial expenses.

Disbursements that are generally to be made from income of the trust include all other ordinary expenses of administration of the trust and recurring insurance premiums.

Disbursements that are generally to be made from principal of the trust include: costs of preparing property for sale when those costs are calculated on the principal; payments on the principal of the trust's debts; expenses incurred to protect the property of the trust; insurance expenses; taxes; and environmental expenses such as reclamation and remediation.

Amended Bill Compared to Substitute Bill:

The amendment makes a technical clarification of the relationship between a trustee's duty of impartiality and the trustee's authority to make adjustments between principal and income.

Appropriation: None.

Fiscal Note: Not Requested.

Effective Date of Amended Bill: Ninety days after adjournment of session in which bill is passed.

Testimony For: About 20 states have already adopted some version of this new principal and income act. It is important that modernization and uniformity be brought to this law, especially for entities that may act as trustees in many jurisdictions. The bill is needed, in part, because many modern assets aren't easily characterized under the current law's standards as principal or income. The bill has many excellent detailed rules for dealing with modern trusts, but it also provides needed authority for a trustee to make sound decisions regarding the overall best interests of a trust. It also provides a way to convert an existing trust into a modern unitrust instead of having to make adjustments to the principal and income of the trust every year.

Testimony Against: None.

Testified: Michael Carrico, Washington State Bar Association, Estate and Gift Tax

Committee.