

Department of Legislative Services
Maryland General Assembly
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FISCAL NOTE
Revised

Senate Bill 641

(Senator Baker)

Judicial Proceedings

Judiciary

**Uniform Principal and Income Act - Unitrust Conversion - Adjustments Between
Principal and Income**

This bill authorizes a trustee to convert a trust to a unitrust or to make adjustments between the principal and income of a trust under certain circumstances.

The bill applies to each trust or decedent's estate existing on or after October 1, 2002.

Fiscal Summary

State Effect: None. The bill does not directly affect governmental operations or finances.

Local Effect: None.

Small Business Effect: Minimal.

Analysis

Bill Summary: This bill presents trustees with two options for providing a fair distribution of income to the income beneficiaries of a trust while maximizing the return on trust assets. These options include: (1) converting to a unitrust; or (2) making equitable adjustments between the principal and income of the trust.

Before exercising either option, the following conditions must be met:

- there must be a written request from a beneficiary to exercise the power conferred to make either the conversion to a unitrust or an adjustment to principal and income;
- the trustee must invest and manage the trust assets in accordance with Maryland's version of the prudent investor rule; and
- the trustee must comply with the notice requirements provided for in the bill and all the beneficiaries must consent or a court must approve the action.

In the case of a conversion, the trustee must also determine that the conversion will enable the trustee to better carry out the intent of the person who created the trust and the purposes of the trust.

In the case of an adjustment between principal and income, the following conditions also apply:

- the terms of the trust must describe the amount that may or must be distributed to a beneficiary by referring to the income of the trust;
- the trustee must determine, after applying the statutory rules governing allocation of receipts and disbursements to or between principal and income, that the trustee is unable to administer the trust fairly and impartially, based on what is fair and reasonable to all of the beneficiaries; and
- the trustee must determine that conversion to a unitrust is an inappropriate method to comply with the statutory duty to administer the trust fairly and impartially, based on what is fair and reasonable to all of the beneficiaries.

Before implementing either option, trustees are required to consider a number of factors, including the nature, purpose, and expected duration of the trust; the intent of the creator of the trust; the identity and circumstances of the beneficiaries; the needs for liquidity, regularity of income, and preservation and appreciation of capital; the nature of the trust assets; and the economic conditions and effects of inflation and deflation. The trustees must also consider the anticipated tax consequences that would result from either action.

The Unitrust Approach

After conversion to a unitrust, a trustee must distribute to the beneficiary an annual amount equal to 4% of the net fair market value of the trust assets. For this purpose, trust assets are averaged over the three preceding years or over the period of the existence of the trust, whichever is less.

An order of priority is established for payment of unitrust distributions. Distributions must be made first from income, as determined as if the trust were not a unitrust. To the extent the net income is insufficient, the trustee may determine to make the distribution next from net realized short-term capital gains, then from net realized long-term capital gains and, finally, distributions may be made from the principal of the trust. Provisions in the governing instrument regarding distribution or withdrawal of principal are not affected by the conversion to a unitrust.

A trustee is required to determine the effect of other payments from or contributions to the trust on the valuation of the trust, whether and how often to value the nonliquid assets of the trust, and whether to omit property occupied or possessed by a beneficiary in the calculation of the assets of the trust.

If authorized by a court order, the trustee may pay more or less than 4% to the income beneficiaries or average the valuation of the assets of the trust over a period other than three years. A beneficiary of the trust has the right to request the trustee to reconvert from a unitrust.

Exercise of the power to convert a trust to a unitrust is prohibited in certain circumstances. The purpose of these limitations is generally to preserve tax benefits, such as marital or charitable tax deductions or gift tax exclusions, or to prevent adverse tax consequences. The power to adjust is also denied to a trustee who is a beneficiary of a trust.

Trustees' Power to Adjust

Unless authorized by a court order, this bill prohibits a trustee from adjusting principal and income, if the adjustment would result in a distribution that is either: (1) greater than 4% of the net fair market value of the assets held in the trust on the first business day of that accounting period if the net income for that period is less than 4%; or (2) less than 4% of the net fair market values of the assets held in the trust on the first business day of that accounting period if the net income for that period is greater than 4%.

The bill also prohibits trustees from making adjustments that would reduce income in a trust which requires that the entire income be paid at least annually to a surviving spouse and includes other limitations to preserve tax benefits and to prevent adverse tax consequences. The power to adjust is also denied to a trustee who is a beneficiary of a trust. Additionally, a trustee may not make an adjustment if the trust has already been converted to a unitrust.

A trustee is permitted to release all or part of the power to adjust in order to avoid adverse tax consequences. This release may be permanent or for a specified period including a period measured by the life of an individual.

A trustee must give notice to the beneficiaries and the creator of the trust of a proposed decision regarding the exercise or nonexercise of the discretionary power to convert or adjust between principal and income. If any beneficiary does not consent to the proposed decision, the trustee or any beneficiary may file a petition to review the proposed decision in the circuit court for the county in which the trustee resides in this State, if the trustee is an individual, or in which the principal place of business of the trustee is located in this State. The sole remedy in the proceeding is to direct, deny, or revise the conversion or the adjustment between principal and income.

Any action taken or not taken in accordance with the provisions of the bill is binding on the trustee, beneficiaries, and any other person with a present or future interest in the trust, and the trustee is not liable for that action.

The bill also amends existing § 15-528 of the Estates and Trusts Article to require a trustee to make an adjustment from principal to income to compensate an income beneficiary for taxes paid or payable by the income beneficiary in respect of the taxable income of an entity that is taxable to the income beneficiary but that is distributed to the trustee and allocated to principal.

Current Law: A trustee may exercise discretionary power in the administration of a trust, but the trustee is held to the duty of acting in a way that is fair and reasonable to all of the beneficiaries, unless the trust specifies otherwise. There is no specific provision for the conversion of a trust to a unitrust or for adjustments between principal and income. Additionally, there is not any legal protection for trustees if they make such a conversion or adjustment even if the conversion or adjustment is made according to prudent investment rules.

Background: In the 2000 session, the General Assembly passed Senate Bill 636 (Chapter 292 of 2000), which enacted the revised Uniform Principal and Income Act promulgated by the National Conference of Commissioners on Uniform State Laws in 1997 (UPIA 1997). The bill established default rules for the trustee of a trust or the personal representative of a decedent's estate to follow in determining whether receipts and disbursements should be classified as principal or income when the governing will or trust instrument is silent.

However, a major provision of UPIA 1997, Section 104, which would have allowed a trustee to adjust principal and income to the extent made necessary by prudent investment

rules when a trust provides for a fixed income for the income beneficiary was omitted from Senate Bill 636.

This bill enacts a modified version of Section 104 that allows a trustee to convert the trust to a unitrust or make an adjustment between principal and income if a written request is received from a beneficiary. The provisions of the bill also vary from the uniform act by requiring a trustee to give notice of a proposed decision to convert or adjust and by protecting a trustee from liability for actions taken in accordance with the bill.

The amendment to § 15-528 of the Estates and Trusts Article addresses a problem that arises when subchapter “S” corporation stock is owned by a trust that qualifies as a “qualified subchapter S trust” (QSST) and the S corporation engages in a partial or complete liquidation. The proceeds of the liquidation are paid to the trustee as a trust receipt. Under normal principal and income rules (ET § 15-508(c)(3)), receipts from the liquidation are allocated to principal, but under the QSST election, any ordinary income or capital gain generated by the liquidation flows through to the income beneficiary who must pay the income taxes. The bill makes it clear that in this situation the trustee must reimburse the income beneficiary for income taxes paid by the income beneficiary on the corporate distributions that are allocated to trust principal and not distributed to the income beneficiary.

Additional Information

Prior Introductions: SB 662 of 2001, a similar bill, passed both the Senate and House, but the Senate did not concur with amendments added by the House. The cross file, HB 956, passed the House but was not reported out of the Senate Judicial Proceedings Committee.

Cross File: HB 881 (Delegates Dembrow and Vallario) – Judiciary.

Information Source(s): Department of Assessments and Taxation, Register of Wills, Comptroller’s Office (Bureau of Revenue Estimates), Department of Legislative Services

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