Colorado T&E Section Statutory Revisions Committee on the

Uniform Fiduciary Income and Principal Act

By: Jonathan F. Haskell

Date: November 6, 2019

UFIPA Section	Section 501
Section Title	Disbursement from Income
Statutory Language	Section 501. Disbursement from Income. Subject to Section 504, and except as otherwise provided in Section 601(c)(2) or (3), a fiduciary shall disburse from income: (1) one-half of: (A) the regular compensation of the fiduciary and any person providing investment advisory, custodial, or other services to the fiduciary, to the extent income is sufficient; and (B) an expense for an accounting, judicial or nonjudicial proceeding, or other matter that involves both income and successive interests, to the extent income is sufficient; (2) the balance of the disbursements described in paragraph (1), to the extent a fiduciary that is an independent person determines that making those disbursements from income would be in the interests of the beneficiaries; (3) another ordinary expense incurred in connection with administration, management, or preservation of property and distribution of income, including interest, an ordinary repair, regularly recurring tax assessed against principal, and an expense of an accounting, judicial or nonjudicial proceeding, or other matter that involves primarily an income interest, to the extent income is sufficient; and (4) a premium on insurance covering loss of a principal asset or income from or use of the asset.
Uniform Law Commission Comments	Although the 2018 Act updates the choice of words and word order to match more recent usage, there are few substantive changes in Article 5. The phrase "to the extent income is sufficient" is added at the end of Section 501(1)(A) and (B) and (3) to acknowledge and accommodate illiquid, low-income-producing trusts. And, as

	that phrase protects income, paragraph (2) protects principal by allowing more than one-half of the disbursements described in this section to be paid from income. One reason, for example, would be that principal is illiquid. Reimbursements under Sections 504 and 505 may be available.
Current Colorado Law	*Uniform Principal and Income Act:* **§ 15-1-426. Disbursements from income.** (1) A trustee shall make the following disbursements from income to the extent that they are not disbursements governed by the provisions of section 15-1-406(1)(b)(II) or (1)(b)(III): (a) One-half of the regular compensation of the trustee and of any person providing investment advisory or custodial services to the trustee; (b) One-half of all expenses for accountings, judicial proceedings, or other matters that involve both the income and remainder interests; (c) 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; and (d) Recurring premiums on insurance covering the loss of a principal asset or the loss of income from or use of the asset.
Official Comments to Colorado Law C.R.S. § 15-1-426	**Trustee fees.** The regular compensation of a trustee or the trustee's agent includes compensation based on a percentage of either principal or income or both. **Insurance premiums.** The reference in paragraph (1)(d) to "recurring" premiums is intended to distinguish premiums paid annually for fire insurance from premiums on title insurance, each of which covers the loss of a principal asset. Title insurance premiums would be a principal disbursement under Section 15-1-427(1)(e).

	Regularly recurring taxes. The reference to "regularly recurring taxes assessed against principal" includes all taxes regularly imposed on real property and tangible and intangible personal property.
Colorado Subcommittee Comment	
Colorado Subcommittee Recommendation	

Colorado T&E Section Statutory Revisions Committee on the

Uniform Fiduciary Income and Principal Act

By: Jonathan F. Haskell

Date: November 6, 2019

UFIPA Section	Section 502
Section Title	Disbursement from Principal
Statutory Language	Section 502. Disbursement from Principal. (a) Subject to Section 505, and except as otherwise provided in Section 601(c)(2), a fiduciary shall disburse from principal: (1) the balance of the disbursements described in Section 501(1) and (3), after application of Section 501(2); (2) the fiduciary's compensation calculated on principal as a fee for acceptance, distribution, or termination; (3) a payment of an expense to prepare for or execute a sale or other disposition of property; (4) a payment on the principal of a trust debt; (5) a payment of an expense of an accounting, judicial or nonjudicial proceeding, or other matter that involves primarily principal, including a proceeding to construe the terms of the trust or protect property; (6) a payment of a premium for insurance, including title insurance, not described in Section 501(4), of which the fiduciary is the owner and beneficiary; (7) a payment of an estate or inheritance tax or other tax imposed because of the death of a decedent, including penalties, apportioned to the trust; and (8) a payment: (A) related to environmental matters, including: (i) reclamation; (ii) assessing environmental conditions;

	(iii) remedying and removing environmental contamination; (iv) monitoring remedial activities and the release of substances; (v) preventing future releases of substances; (vi) collecting amounts from persons liable or potentially liable for the costs of activities described in clauses (i) through (v); (vii) penalties imposed under environmental laws or regulations; (viii) other actions to comply with environmental laws or regulations; (ix) statutory or common law claims by third parties; and (x) defending claims based on environmental matters; and (B) for a premium for insurance for matters described in subparagraph (A). (b) If a principal asset is encumbered with an obligation that requires income from the asset to be paid directly to a creditor, the fiduciary shall transfer from principal to income an amount equal to the income paid to the creditor in reduction of the principal balance of the obligation.
Uniform Law Commission Comments	The 2018 Act replaces “the remaining one-half” at the beginning of Section 502(a)(1) in the 1997 Act with “the balance.” This conforms to the changes to Section 501 that make it more likely that traditional 50-50 splits will not necessarily be followed. Reimbursements under Sections 504 and 505 may be available. A reference to title insurance is added to Section 502(a)(6). The 1997 Act added the detailed provisions regarding environmental remediation in what is now Section 502(a)(8)(A). The 2018 Act adds to those provisions a reference in subparagraph (B) to insurance premiums.

Current Colorado Law	*Uniform Principal and Income Act:* **§ 15-1-427. Disbursements from principal** (1) A trustee shall make the following disbursements from principal: (a) The remaining one-half of the disbursements described in section 15-1-426(1)(a) and section 15-1-426(1)(b); (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; (c) Payments on the principal of a trust debt; (d) Expenses of a proceeding that concerns primarily principal, including a proceeding to construe the trust or to protect the trust or its property; (e) Premiums paid on a policy of insurance not described in section 15-1-426(1)(d) of which the trust is the owner and beneficiary; (f) Estate, inheritance, and other transfer taxes, including penalties, apportioned to the trust; and (g) Disbursements related to environmental matters, including reclamation, assessing environmental conditions, remedying and removing environmental contamination, monitoring remedial activities and the release of substances, preventing future releases of substances, collecting amounts from persons liable or potentially liable for the costs of those activities, penalties imposed under environmental laws or regulations and other payments made to comply with those laws or regulations, statutory or common law claims by third parties, and defending claims based on environmental matters. (2) If a principal asset is encumbered with an obligation that requires income from that asset to be paid directly to the creditor, the trustee shall transfer from principal to income an amount equal to the income paid to the creditor in reduction of the principal balance of the obligation.
Official Comments to Colorado Law	**Environmental expenses.** All environmental expenses are payable from principal, subject to the power of the trustee to

C.R.S. § 15-1-427	transfer funds to principal from income under Section 15-1-429. However, the Drafting Committee decided that it was not necessary to broaden this provision to cover other expenditures made under compulsion of governmental authority. See generally the annotation at 43 A.L.R.4th 1012 (Duty as Between Life Tenant and Remainderman with Respect to Cost of Improvements or Repairs Made Under Compulsion of Governmental Authority). Environmental expenses paid by a trust are to be paid from principal under Section 15-1-502(1)(g) on the assumption that they will usually be extraordinary in nature. Environmental expenses might be paid from income if the trustee is carrying on a business that uses or sells toxic substances, in which case environmental cleanup costs would be a normal cost of doing business and would be accounted for under Section 15-1-413. In accounting under that Section, environmental costs will be a factor in determining how much of the net receipts from the business is trust income. Paying all other environmental expenses from principal is consistent with this Act's approach regarding receipts -- when a receipt is not clearly a current return on a principal asset, it should be added to principal because over time both the income and remainder beneficiaries benefit from this treatment. Here, allocating payments required by environmental laws to principal imposes the detriment of those payments over time on both the income and remainder beneficiaries. Under Sections 15-1-429(1) and 15-1-429(2)(e), a trustee who makes or expects to make a principal disbursement for an environmental expense described in Section 15-1-427(1)(g) is authorized to transfer an appropriate amount from income to principal to reimburse principal for disbursements made or to provide a reserve for future principal disbursements. The first part of Section 15-1-427(1)(g) is based upon the definition of an "environmental remediation trust" in Treas. Reg. § 301.7701-4(e) (as amended in 1996). This is not because the Act applies to an environmental remediation trust, but because the definition is a useful and thoroughly vetted description of the kinds of expenses that a trustee owning contaminated property might incur. Expenses incurred to comply with environmental laws include the cost of environmental consultants, administrative proceedings and burdens of every kind imposed as the result of an administrative or judicial proceeding, even though the burden is not formally characterized as a penalty.

	Title proceedings. Disbursements that are made to protect a trust's property, referred to in Section 15-1-427(1)(d), include an "action to assure title" that is mentioned in Section 13(c)(2) of the 1962 Uniform Act. **Insurance premiums.** Insurance premiums referred to in Section 15-1-427(1)(e) include title insurance premiums. They also include premiums on life insurance policies owned by the trust, which represent the trust's periodic investment in the insurance policy. There is no provision in the 1962 Uniform Act for life insurance premiums. **Taxes.** Generation-skipping transfer taxes are payable from principal under subsection (1)(f).
Colorado Subcommittee Comment	
Colorado Subcommittee Recommendation	

Colorado T&E Section Statutory Revisions Committee on the

Uniform Fiduciary Income and Principal Act

By: Jonathan F. Haskell

Date: November 6, 2019

UFIPA Section	Section 503
Section Title	Transfer from Income to Principal for Depreciation
Statutory Language	Section 503. Transfer from Income to Principal for Depreciation. (a)In this section, "depreciation" means a reduction in value due to wear, tear, decay, corrosion, or gradual obsolescence of a tangible asset having a useful life of more than one year. (b) A fiduciary may transfer to principal a reasonable amount of the net cash receipts from a principal asset that is subject to depreciation, but may not transfer any amount for depreciation: (1) of the part of real property used or available for use by a beneficiary as a residence; (2) of tangible personal property held or made available for the personal use or enjoyment of a beneficiary; or (3) under this section, to the extent the fiduciary accounts: (A) under Section 410 for the asset; or (B) under Section 403 for the business or other activity in which the asset is used. (c) An amount transferred to principal under this section need not be separately held.
Uniform Law Commission Comments	The 2018 Act changes "fixed" to "tangible" in the definition of depreciation in Section 503(a). The references to "a residence" and "tangible personal property" in Section 503(b)(1) are broken up into paragraphs (1) and (2), for ease of reading, and to avoid implying that the two topics are linked so that, for example, the tangible personal property described must be household furnishings. The 2018 Act also adds Section 503(b)(3)(A) to expand the exception from the depreciation rule to assets accounted for separately as liquidating assets under Section 410, as well in a business under Section 403.

Current Colorado Law	*Uniform Principal and Income Act:* **§ 15-1-428. Transfers from income to principal for depreciation** (1) For purposes of this section, "depreciation" means a reduction in value due to wear, tear, decay, corrosion, or gradual obsolescence of a fixed asset having a useful life of more than one year. (2) A trustee may transfer to principal a reasonable amount of the net cash receipts from a principal asset that is subject to depreciation, but may not transfer any amount for depreciation: (a) Of that portion of real property used or available for use by a beneficiary as a residence or of tangible personal property held or made available for the personal use or enjoyment of a beneficiary; (b) During the administration of a decedent's estate; or (c) Under this section if the trustee is accounting under section 15-1-413 for the business or activity in which the asset is used. (3) An amount transferred to principal need not be held as a separate fund.
Official Comments to Colorado Law C.R.S. § 15-1-428	**Prior Acts.** The 1931 Uniform Act has no provision for depreciation. Section 13(a)(2) of the 1962 Uniform Act provides that a charge shall be made against income for "... a reasonable allowance for depreciation on property subject to depreciation under generally accepted accounting principles ... ." That provision has been resisted by many trustees, who do not provide for any depreciation for a variety of reasons. One reason relied upon is that a charge for depreciation is not needed to protect the remainder beneficiaries if the value of the land is increasing; another is that generally accepted accounting principles may not require depreciation to be taken if the property is not part of a business. The Drafting Committee concluded that the decision to provide for depreciation should be discretionary with the trustee. The power to transfer funds from income to principal that is granted by this section is a discretionary power of administration referred to in Section 15-1-403(2), and in exercising the power a trustee must comply with Section 15-1-403(2).

	One purpose served by transferring cash from income to principal for depreciation is to provide funds to pay the principal of an indebtedness secured by the depreciable property. Section 15-1-429(2)(d) permits the trustee to transfer additional cash from income to principal for this purpose to the extent that the amount transferred from income to principal for depreciation is less than the amount of the principal payments.
Colorado Subcommittee Comment	
Colorado Subcommittee Recommendation	

Colorado T&E Section Statutory Revisions Committee on the

Uniform Fiduciary Income and Principal Act

By: Jonathan F. Haskell

Date: November 6, 2019

UFIPA Section	Section 504
Section Title	Reimbursement of Income from Principal
Statutory Language	Section 504. Reimbursement of Income from Principal. (a) If a fiduciary makes or expects to make an income disbursement described in subsection (b), the fiduciary may transfer an appropriate amount from principal to income in one or more accounting periods to reimburse income. (b) To the extent the fiduciary has not been and does not expect to be reimbursed by a third party, income disbursements to which subsection (a) applies include: (1) an amount chargeable to principal but paid from income because principal is illiquid; (2) a disbursement made to prepare property for sale, including improvements and commissions; and (3) a disbursement described in Section 502(a). (c) If an asset whose ownership gives rise to an income disbursement becomes subject to a successive interest after an income interest ends, the fiduciary may continue to make transfers under subsection (a).
Uniform Law Commission Comments	Section 504, Transfers from Income to Reimburse Principal, in the 1997 Act is redesignated Section 505, Reimbursement of Principal from Income, in the 2018 Act. New Section 504, Reimbursement of Income from Principal, is the mirror image of Section 505, with the result that reimbursements in both directions are now covered in the same way. Crossreferences to these sections are added at the beginning of Sections 501 and 502. The order of Sections 504 and 505 was selected with reference to the corresponding Sections 501 and 502. Section 501 is “Subject to Section 504,” and Section 502 is “Subject to Section 505.” The term “successive income interest” in Section 504(c) of the 1997 Act is changed to simply “successive interest” in Sections

	504(c) and 505(c) of the 2018 Act, because that is now the defined term in Section 102(20). Even though a "successive interest" includes the interest of a person entitled to receive principal – that is, a remainder beneficiary – when an income interest ends, that does not mean that Section 504 or 505 would continue to apply after a trust terminates, because the terms of the trust providing for termination would control under Section 201(a)(3).
Current Colorado Law	*Uniform Principal and Income Act:* No Colorado Law on Section 504
Official Comments to Colorado Law C.R.S. §	
Colorado Subcommittee Comment	
Colorado Subcommittee Recommendation	

Colorado T&E Section Statutory Revisions Committee on the

Uniform Fiduciary Income and Principal Act

By: Jonathan F. Haskell

Date: November 6, 2019

UFIPA Section	Section 505
Section Title	Reimbursement of Principal from Income
Statutory Language	Section 505. Reimbursement of Principal from Income. (a) If a fiduciary makes or expects to make a principal disbursement described in subsection (b), the fiduciary may transfer an appropriate amount from income to principal in one or more accounting periods to reimburse principal or provide a reserve for future principal disbursements. (b) To the extent a fiduciary has not been and does not expect to be reimbursed by a third party, principal disbursements to which subsection (a) applies include: (1) an amount chargeable to income but paid from principal because income is not sufficient; (2) the cost of an improvement to principal, whether a change to an existing asset or the construction of a new asset, including a special assessment; (3) a disbursement made to prepare property for rental, including tenant allowances, leasehold improvements, and commissions; (4) a periodic payment on an obligation secured by a principal asset, to the extent the amount transferred from income to principal for depreciation is less than the periodic payment; and (5) a disbursement described in Section 502(a). (c) If an asset whose ownership gives rise to a principal disbursement becomes subject to a successive interest after an income interest ends, the fiduciary may continue to make transfers under subsection (a).
Uniform Law Commission Comments	None

Current Colorado Law	*Uniform Principal and Income Act:* **§ 15-1-429. Transfers from income to reimburse principal.** (1) If a trustee makes or expects to make a principal disbursement described in this section, the trustee may transfer an appropriate amount from income to principal in one or more accounting periods to reimburse principal or to provide a reserve for future principal disbursements. (2) Principal disbursements governed by the provisions of subsection (1) of this section include the following, but only to the extent that the trustee has not been and does not expect to be reimbursed by a third party: (a) An amount chargeable to income but paid from principal because it is unusually large, including extraordinary repairs; (b) A capital improvement to a principal asset, whether in the form of changes to an existing asset or the construction of a new asset, including special assessments; (c) Disbursements made to prepare property for rental, including tenant allowances, leasehold improvements, and broker's commissions; (d) Periodic payments on an obligation secured by a principal asset to the extent that the amount transferred from income to principal for depreciation is less than the periodic payments; and (e) Disbursements described in section 15-1-427(1)(g). (3) If the asset whose ownership gives rise to the disbursements becomes subject to a successive income interest after an income interest ends, a trustee may continue to transfer amounts from income to principal as provided in subsection (1) of this section.
Official Comments to Colorado Law C.R.S. § 15-1-429	**Prior Acts.** The sources of Section 15-1-429 are Section 13(b) of the 1962 Uniform Act, which permits a trustee to "regularize distributions," if charges against income are unusually large, by

	using "reserves or other reasonable means" to withhold sums from income distributions; Section 13(c)(3) of the 1962 Uniform Act, which authorizes a trustee to establish an allowance for depreciation out of income if principal is used for extraordinary repairs, capital improvements and special assessments; and Section 12(3) of the 1931 Uniform Act, which permits the trustee to spread income expenses of unusual amount "throughout a series of years." Section 15-1-429 contains a more detailed enumeration of the circumstances in which this authority may be used, and includes in subsection (2)(d) the express authority to use income to make principal payments on a mortgage if the depreciation charge against income is less than the principal payments on the mortgage.
Colorado Subcommittee Comment	
Colorado Subcommittee Recommendation	

Colorado T&E Section Statutory Revisions Committee on the

Uniform Fiduciary Income and Principal Act

By: Jonathan F. Haskell

Date: November 6, 2019

UFIPA Section	Section 506
Section Title	Income Taxes
Statutory Language	Section 506. Income Taxes. (a) A tax required to be paid by a fiduciary which is based on receipts allocated to income must be paid from income. (b) A tax required to be paid by a fiduciary which is based on receipts allocated to principal must be paid from principal, even if the tax is called an income tax by the taxing authority. (c) Subject to subsection (d) and Sections 504, 505, and 507, a tax required to be paid by a fiduciary on a share of an entity's taxable income in an accounting period must be paid from: (1) income and principal proportionately to the allocation between income and principal of receipts from the entity in the period; and (2) principal to the extent the tax exceeds the receipts from the entity in the period. (d) After applying subsections (a) through (c), a fiduciary shall adjust income or principal receipts, to the extent the taxes the fiduciary pays are reduced because of a deduction for a payment made to a beneficiary.
Uniform Law Commission Comments	**Marital deduction issues.** Any payment of income tax from income could raise issues of the estate or gift tax marital deduction, especially if the income on which that income tax is paid is not fully distributed, as in the case of income retained in an entity owned in whole or in part by the trust. These issues are similar to the issues raised by Revenue Ruling 2006-26 in the context of defined contribution qualified retirement plans and individual retirement accounts (IRAs). See Section 409 and the Comment thereto. The 2018 Act makes no change to Section 506 because the power in the spouse to cause the trust assets to be made reasonably productive of income addresses any marital deduction issue. See Section 413.

Comment to 2008 Amendments of 1997 Act

Taxes on Undistributed Entity Taxable Income. When a nongrantor trust owns an interest in a pass-through entity, such as a partnership or S corporation, it must report its share of the entity's taxable income regardless of how much the entity distributes to the trust. Whether the entity distributes more or less than the trust's tax on its share of the entity's taxable income, the trust must pay the taxes and allocate them between income and principal.

Subsection (c) requires the trust to pay the taxes on its share of an entity's taxable income from income or principal receipts to the extent that receipts from the entity are allocable to each. This assures the trust a source of cash to pay some or all of the taxes on its share of the entity's taxable income. Subsection (d) recognizes that, except in the case of an Electing Small Business Trust (ESBT), a trust normally receives a deduction for amounts distributed to a beneficiary. Accordingly, subsection (d) requires the trust to increase receipts payable to a beneficiary as determined under subsection (c) to the extent the trust's taxes are reduced by distributing those receipts to the beneficiary.

Because the trust's taxes and amounts distributed to a beneficiary are interrelated, the trust may be required to apply a formula to determine the correct amount payable to a beneficiary. This formula should take into account that each time a distribution is made to a beneficiary, the trust taxes are reduced and amounts distributable to a beneficiary are increased. The formula assures that after deducting distributions to a beneficiary, the trust has enough to satisfy its taxes on its share of the entity's taxable income as reduced by distributions to beneficiaries.

Example (1) – Trust T receives a Schedule K-1 from Partnership P reflecting taxable income of $1 million. Partnership P distributes $100,000 to T, which allocates the receipts to income. Both Trust T and income Beneficiary B are in the 35 percent tax bracket.

Trust T's tax on $1 million of taxable income is $350,000. Under Subsection (c) T's tax must be paid from income receipts because receipts from the entity are allocated only to income. Therefore, T must apply the entire $100,000 of income receipts to pay its tax. In this case, Beneficiary B receives nothing.

Example (2) – Trust T receives a Schedule K-1 from Partnership P reflecting taxable income of $1 million. Partnership P distributes $500,000 to T, which allocates the receipts to income. Both Trust T and income Beneficiary B are in the 35 percent tax bracket.

Trust T's tax on $1 million of taxable income is $350,000. Under Subsection (c), T's tax must be paid from income receipts because receipts from P are allocated only to income. Therefore, T uses $350,000 of the $500,000 to pay its taxes and distributes the remaining $150,000 to B. The $150,000 payment to B reduces T's taxes by $52,500, which it must pay to B. But the $52,500 further reduces T's taxes by $18,375, which it also must pay to B. In fact, each time T makes a distribution to B, its taxes are further reduced, causing another payment to be due B.

Alternatively, T can apply the following algebraic formula to determine the amount payable to B:

$D = (C-R\times K)/(1-R)$
D = Distribution to income beneficiary
C = Cash paid by the entity to the trust
R = tax rate on income
K = entity's K-1 taxable income

Applying the formula to Example (2) above, Trust T must pay $230,769 to B so that after deducting the payment, T has exactly enough to pay its tax on the remaining taxable income from P.

Taxable Income per K-1	$1,000,000
Payment to beneficiary	230,769
Trust Taxable Income	$ 769,231
35 percent tax	269,231

Partnership Distribution	$ 500,000
Fiduciary's Tax Liability	(269,231)
Payable to the Beneficiary	$ 230,769

The "payment to beneficiary" is calculated as $(C-R\times K)/(1-R)$ = $(500{,}000-0.35\times 1{,}000{,}000)/(10.35)$ = $(500{,}000-350{,}000)/(1-0.35)$ = $150{,}000/0.65$ = $230,769 (where C is the cash distributed by the entity, R is the trust ordinary tax rate (35%), and K is the entity's K-1 taxable income).

In addition, B will report $230,769 on his or her own personal income tax return, paying taxes of $80,769. Because Trust T

	withheld $269,231 to pay its taxes and B paid $80,769 taxes of its own, B bore the entire $350,000 tax burden on the $1 million of entity taxable income, including the $500,000 that the entity retained that presumably increased the value of the trust's investment entity. If a trustee determines that it is appropriate to so, it should consider exercising the discretion granted in RUPIA section 506 [now 507] to adjust between income and principal. Alternatively, the trustee may exercise the power to adjust under RUPIA section 104 [now 203] to the extent it is available and appropriate under the circumstances, including whether a future distribution from the entity that would be allocated to principal should be reallocated to income because the income beneficiary already bore the burden of taxes on the reinvested income. In exercising the power, the trust should consider the impact that future distributions will have on any current adjustments.
Current Colorado Law	*Uniform Principal and Income Act:* **§ 15-1-430. Income taxes.** (1) A tax required to be paid by a trustee based on receipts allocated to income must be paid from income. (2) A tax required to be paid by a trustee based on receipts allocated to principal must be paid from principal, even if the tax is called an income tax by the taxing authority. (3) A tax required to be paid by a trustee on the trust's share of an entity's taxable income must be paid: (a) From income to the extent that receipts from the entity are allocated only to income; (b) From principal to the extent that receipts from the entity are allocated only to principal; (c) Proportionately from principal and income to the extent that receipts from the entity are allocated to both income and principal; and (d) From principal to the extent that the tax exceeds the total receipts from the entity.

	(4) After applying subsections (1) to (3) of this section, the trustee shall adjust income or principal receipts to the extent that the trust's taxes are reduced because the trust receives a deduction for payments made to a beneficiary.
Official Comments to Colorado Law C.R.S. § 15-1-430	**Electing Small Business Trusts.** An Electing Small Business Trust (ESBT) is a creature created by Congress in the Small Business Job Protection Act of 1996 (P.L. 104-188). For years beginning after 1996, an ESBT may qualify as an S corporation stockholder even if the trustee does not distribute all of the trust's income annually to its beneficiaries. The portion of an ESBT that consists of the S corporation stock is treated as a separate trust for tax purposes (but not for trust accounting purposes), and the S corporation income is taxed directly to that portion of the trust even if some or all of that income is distributed to the beneficiaries. A trust normally receives a deduction for distributions it makes to its beneficiaries. Subsection (4) takes into account the possibility that an ESBT may not receive a deduction for trust accounting income that is distributed to the beneficiaries. Only limited guidance has been issued by the Internal Revenue Service, and it is too early to anticipate all of the technical questions that may arise, but the powers granted to a trustee in Sections 15-1-431 and 15-1-404 to make adjustments are probably sufficient to enable a trustee to correct inequities that may arise because of technical problems.
Colorado Subcommittee Comment	
Colorado Subcommittee Recommendation	

Colorado T&E Section Statutory Revisions Committee on the

Uniform Fiduciary Income and Principal Act

By: Jonathan F. Haskell

Date: November 6, 2019

UFIPA Section	Section 507
Section Title	Adjustment Between Income and Principal Because of Taxes
Statutory Language	Section 507. Adjustment Between Income and Principal Because of Taxes. (a) A fiduciary may make an adjustment between income and principal to offset the shifting of economic interests or tax benefits between current income beneficiaries and successor beneficiaries which arises from: (1) an election or decision the fiduciary makes regarding a tax matter, other than a decision to claim an income tax deduction to which subsection (b) applies; (2) an income tax or other tax imposed on the fiduciary or a beneficiary as a result of a transaction involving the fiduciary or a distribution by the fiduciary; or (3) ownership by the fiduciary of an interest in an entity a part of whose taxable income, whether or not distributed, is includable in the taxable income of the fiduciary or a beneficiary. (b) If the amount of an estate tax marital or charitable deduction is reduced because a fiduciary deducts an amount paid from principal for income tax purposes instead of deducting it for estate tax purposes and, as a result, estate taxes paid from principal are increased and income taxes paid by the fiduciary or a beneficiary are decreased, the fiduciary shall charge each beneficiary that benefits from the decrease in income tax to reimburse the principal from which the increase in estate tax is paid. The total reimbursement must equal the increase in the estate tax, to the extent the principal used to pay the increase would have qualified for a marital or charitable deduction but for the payment. The share of the reimbursement for each fiduciary or beneficiary whose income taxes are reduced must be the same as its share of the total decrease in income tax.

	(c) A fiduciary that charges a beneficiary under subsection (b) may offset the charge by obtaining payment from the beneficiary, withholding an amount from future distributions to the beneficiary, or adopting another method or combination of methods.
Uniform Law Commission Comments	**Mandatory adjustments.** The adjustments addressed by Section 507 are derived from the history of "equitable adjustments" largely associated with New York case law. For example, *Matter of Warms*, 140 N.Y.S.2d 169 (1955), involved estate administration expenses chargeable to principal that are allowed as either estate tax deductions or income tax deductions. If the items are claimed as income tax deductions and benefit income, *Warms* requires income to reimburse principal for any increased estate taxes. *The Warms* adjustment has been codified in some states, including New York in EPTL §11-2.1(a). Subsection (b), which requires reimbursement of principal from income, is derived from New York's EPTL §11-2.1(a). Unlike the New York statute, however, it limits the mandatory reimbursement to cases in which a marital or charitable deduction is reduced by the payment of additional estate taxes because of the fiduciary's income tax election. It is intended to preserve the result reached in *Estate of Britenstool v. Commissioner*, 46 T.C. 711 (1966), in which the United States Tax Court held that a reimbursement required by the predecessor of EPTL §11-2.1(a) preserved for the estate the same charitable deduction it would have received if the administration expenses had been deducted for estate tax purposes instead of for income tax purposes. Because a fiduciary will typically elect to deduct administration expenses for income tax purposes only when the income tax reduction exceeds the estate tax reduction, the effect of this adjustment is that principal is placed in the same position it would have occupied if the fiduciary had deducted the expenses for estate tax purposes, but the income beneficiaries still receive the additional benefit of the difference in the benefit of the two deductions. For example, if the income tax benefit from the deduction is $30,000 and the estate tax benefit would have been $20,000, principal will be reimbursed by $20,000 and the net benefit to the income beneficiaries will be $10,000. **Other adjustments.** A second occasion for adjustment is a "trapping distribution" – a distribution of principal that carries out income for income tax purposes. *Matter of Holloway*, 68 Misc.2d 361, 327 N.Y.S.2d 865 (1972), held that a trust that made a

	trapping distribution must reimburse principal for the income taxes resulting from the distribution. A third adjustment context arises when a trust's deductible expenses chargeable to principal reduce distributable net income and the taxable income of an income beneficiary, and the trust has taxable gains. Must income reimburse principal for the capital gains taxes that would have been saved if the expenses were used to reduce the gains? A Pennsylvania case, *Rice Estate*, 8 Pa. D&C2d 379 (1956), required an adjustment, but a New York case, *Matter of Dick*, 29 Misc.2d 648, 218 N.Y.S.2d 182 (1961), and a Massachusetts case, *New England Merchants Nat'l Bank v. Converse*, 373 Mass. 639, 369 N.E.2d 982 (1972), rejected an adjustment. A similar New York case, *Matter of Pross*, 90 Misc.2d 895, 396 N.Y.S.2d 309 (1978), required an adjustment from income to principal when a capital gain on a sale of real property resulted from a depreciation deduction that had benefitted the income beneficiary of the trust by reducing distributable net income. Subsection (a) allows adjustments in cases like these, in the fiduciary's discretion (recognizing that local case law and statutory law, other than this Act, may require the exercise of that discretion under this Act). **Changes in the 2018 Act.** Section 506(b) of the 1997 Act required that "each estate, trust, or beneficiary that benefits from the decrease in income tax shall reimburse the principal from which the increase in estate tax is paid." The 2018 Act changes this, in Section 507(b), to "the fiduciary shall charge each beneficiary that benefits from the decrease in income tax to reimburse the principal from which the increase in estate tax is paid" and adds subsection (c) to provide the fiduciary with options for accomplishing the "reimbursement" objective. One option in subsection (c) remains "obtaining payment from the beneficiary," but the possibly more practical option of withholding amounts from future distributions is also included.
Current Colorado Law	*Uniform Principal and Income Act:* **§ 15-1-431. Adjustments between principal and income because of taxes.** (1) A fiduciary may make adjustments between principal and income to offset the shifting of economic interests or tax

	benefits between income beneficiaries and remainder beneficiaries that arise from: (a) Elections and decisions, other than those described in subsection (2) of this section, that the fiduciary makes from time to time regarding tax matters; (b) An income tax or any other tax that is imposed upon the fiduciary or a beneficiary as a result of a transaction involving or a distribution from the estate or trust; or (c) The ownership by an estate or trust of an interest in an entity whose taxable income, whether or not distributed, is includable in the taxable income of the estate, trust, or a beneficiary. (2) If the amount of an estate tax marital deduction or charitable contribution deduction is reduced because a fiduciary deducts an amount paid from principal for income tax purposes instead of deducting it for estate tax purposes, and as a result estate taxes paid from principal are increased and income taxes paid by an estate, trust, or beneficiary are decreased, each estate, trust, or beneficiary that benefits from the decrease in income tax shall reimburse the principal from which the increase in estate tax is paid. The total reimbursement must equal the increase in the estate tax to the extent that the principal used to pay the increase would have qualified for a marital deduction or charitable contribution deduction but for the payment. The proportionate share of the reimbursement for each estate, trust, or beneficiary whose income taxes are reduced must be the same as its proportionate share of the total decrease in income tax. An estate or trust shall reimburse principal from income.
Official Comments to Colorado Law C.R.S. § 15-1-431	**Discretionary adjustments.** Section 15-1-431(1) permits the fiduciary to make adjustments between income and principal because of tax law provisions. It would permit discretionary adjustments in situations like these: (1) A fiduciary elects to deduct administration expenses that are paid from principal on an income tax return instead of on the estate tax return; (2) a distribution of a principal asset to a trust or other beneficiary causes the taxable income of an estate or trust to be carried out to

	the distributee and relieves the persons who receive the income of any obligation to pay income tax on the income; or (3) a trustee realizes a capital gain on the sale of a principal asset and pays a large state income tax on the gain, but under applicable federal income tax rules the trustee may not deduct the state income tax payment from the capital gain in calculating the trust's federal capital gain tax, and the income beneficiary receives the benefit of the deduction for state income tax paid on the capital gain. See generally Joel C. Dobris, Limits on the Doctrine of Equitable Adjustment in Sophisticated Postmortem Tax Planning, 66 Iowa L. Rev. 273 (1981). Section 15-1-431 (1)(c) applies to a qualified Subchapter S trust (QSST) whose income beneficiary is required to include a pro rata share of the S corporation's taxable income in his return. If the QSST does not receive a cash distribution from the corporation that is large enough to cover the income beneficiary's tax liability, the trustee may distribute additional cash from principal to the income beneficiary. In this case the retention of cash by the corporation benefits the trust principal. This situation could occur if the corporation's taxable income includes capital gain from the sale of a business asset and the sale proceeds are reinvested in the business instead of being distributed to shareholders. **Mandatory adjustment.** Subsection (2) provides for a mandatory adjustment from income to principal to the extent needed to preserve an estate tax marital deduction or charitable contributions deduction. It is derived from New York's EPTL § 11-1.2(A), which requires principal to be reimbursed by those who benefit when a fiduciary elects to deduct administration expenses on an income tax return instead of the estate tax return. Unlike the New York provision, subsection (2) limits a mandatory reimbursement to cases in which a marital deduction or a charitable contributions deduction is reduced by the payment of additional estate taxes because of the fiduciary's income tax election. It is intended to preserve the result reached in Estate of Britenstool v. Commissioner, 46 T.C. 711 (1966), in which the Tax Court held that a reimbursement required by the predecessor of EPTL § 11-1.2(A) resulted in the estate receiving the same charitable contributions deduction it would have received if the administration expenses had been deducted for estate tax purposes instead of for income tax purposes. Because a fiduciary will elect to deduct administration expenses for income tax purposes only when the income tax reduction exceeds the estate tax reduction, the effect of this adjustment is that the principal is placed in the

	same position it would have occupied if the fiduciary had deducted the expenses for estate tax purposes, but the income beneficiaries receive an additional benefit. For example, if the income tax benefit from the deduction is $30,000 and the estate tax benefit would have been $20,000, principal will be reimbursed $20,000 and the net benefit to the income beneficiaries will be $10,000. **Irrevocable grantor trusts.** Under Sections 671-679 of the Internal Revenue Code (the "grantor trust" provisions), a person who creates an irrevocable trust for the benefit of another person may be subject to tax on the trust's income or capital gains, or both, even though the settlor is not entitled to receive any income or principal from the trust. Because this is now a well-known tax result, many trusts have been created to produce this result, but there are also trusts that are unintentionally subject to this rule. The Act does not require or authorize a trustee to distribute funds from the trust to the settlor in these cases because it is difficult to establish a rule that applies only to trusts where this tax result is unintended and does not apply to trusts where the tax result is intended. Settlors who intend this tax result rarely state it as an objective in the terms of the trust, but instead rely on the operation of the tax law to produce the desired result. As a result it may not be possible to determine from the terms of the trust if the result was intentional or unintentional. If the drafter of such a trust wants the trustee to have the authority to distribute principal or income to the settlor to reimburse the settlor for taxes paid on the trust's income or capital gains, such a provision should be placed in the terms of the trust. In some situations the Internal Revenue Service may require that such a provision be placed in the terms of the trust as a condition to issuing a private letter ruling.
Colorado Subcommittee Comment	
Colorado Subcommittee Recommendation	