

**CHAPTER 158****(HB 517)**

AN ACT relating to the administration of trusts and estates.

*Be it enacted by the General Assembly of the Commonwealth of Kentucky:*

**ARTICLE 1****DEFINITIONS AND FIDUCIARY DUTIES**

SECTION 1. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

- (1) *"Accounting period" means a calendar year unless another twelve (12) month period is selected by a fiduciary. The term includes a portion of a calendar year or other twelve (12) month period that begins when an income interest begins or ends when an income interest ends;*
- (2) *"Beneficiary" includes, in the case of a decedent's estate, an heir, legatee, and devisee and, in the case of a trust, an income beneficiary and a remainder beneficiary;*
- (3) *"District Court approval" means the consent of:*
  - (a) *All current beneficiaries;*
  - (b) *All remainder beneficiaries in the oldest generation; and*
  - (c) *The court;*
- (4) *"Fiduciary" means a personal representative or a trustee. The term includes an executor, administrator, successor personal representative, and public administrator;*
- (5) *"Income" means money or property that a fiduciary receives as current return from a principal asset. The term includes a portion of receipts from a sale, exchange, or liquidation of a principal asset, to the extent provided in Articles 4 and 5 of the Kentucky Principal and Income Act;*
- (6) *"Income beneficiary" means a person to whom net income of a trust is or may be payable;*
- (7) *"Income interest" means the right of an income beneficiary to receive all or part of net income, whether the terms of the trust require it to be distributed or authorize it to be distributed in the trustee's discretion;*
- (8) *"Mandatory income interest" means the right of an income beneficiary to receive net income that the terms of the trust require the fiduciary to distribute;*
- (9) *"Net income" means the total receipts allocated to income during an accounting period minus the disbursements made from income during the period, plus or minus transfers under Sections 1 to 27 of this Act to or from income during the period;*
- (10) *"Principal" means property held in trust for distribution to a remainder beneficiary when the trust terminates;*
- (11) *"Remainder beneficiary" means a person entitled to receive principal when an income interest ends;*

- (12) *"Terms of a trust" means the manifestation of the intent of a settlor or decedent with respect to the trust, expressed in a manner that admits of its proof in a judicial proceeding, whether by written or spoken words or by conduct; and*
- (13) *"Trustee" includes an original, additional, or successor trustee, whether or not appointed or confirmed by a court.*

SECTION 2. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

- (1) *In allocating receipts and disbursements to or between principal and income, and with respect to any matter within the scope of Articles 2 and 3 of the Kentucky Principal and Income Act, a fiduciary:*
- (a) *Shall administer a trust or estate in accordance with the terms of the trust or the will, even if there is a different provision in Sections 1 to 27 of this Act;*
  - (b) *May administer a trust or estate by the exercise of a discretionary power of administration given to the fiduciary by the terms of the trust or the will, even if the exercise of the power produces a result different from a result required or permitted by Sections 1 to 27 of this Act;*
  - (c) *Shall administer a trust or estate in accordance with Sections 1 to 27 of this Act if the terms of the trust or the will do not contain a different provision or do not give the fiduciary a discretionary power of administration; and*
  - (d) *Shall add a receipt or charge a disbursement to principal to the extent that neither the terms of the trust nor Sections 1 to 27 of this Act provide a rule for allocating the receipt or disbursement to or between principal and income.*
- (2) *In exercising the power to adjust under subsection (2) or (3) of Section 3 of this Act or a discretionary power of administration regarding a matter within the scope of Sections 1 to 27 of this Act, whether granted by the terms of a trust, a will, or Sections 1 to 27 of this Act, a fiduciary shall administer a trust or estate impartially, based on what is fair and reasonable to all of the beneficiaries, except to the extent that the terms of the trust or the will clearly manifest a contrary intention. Except as provided in this subsection, determination in accordance with Sections 1 to 27 of this Act shall be presumed to be fair and reasonable to all of the beneficiaries.*

SECTION 3. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

- (1) *Notwithstanding any provision of Kentucky law to the contrary, the trustee of a trust to which by law KRS 287.277 does not apply may elect to have such provisions apply to the administration of the trust with approval of the District Court.*
- (2) *A trustee may adjust between principal and income to the extent the trustee considers necessary if KRS 287.277 applies by law or by election made and approved under subsection (1) of this Act, the terms of the trust describe the amount that may or shall be distributed to a beneficiary by referring to the trust's income, the trustee determines, after applying the rules in subsection (1) of Section 2 of this Act, that the trustee is unable to comply with subsection (2) of Section 2 of this Act and the adjustment, including an adjustment method such as an annual percentage distribution if the percentage is not less than three percent (3%) nor more than five percent (5%) of the fair market value of the trust assets determined annually, is approved by the District Court.*

- (3) (a) *A personal representative may adjust between principal and income in the same manner as a trustee if KRS 287.277 applies to the personal representative by law or if the personal representative elects to have KRS 287.277 apply to the administration of the estate, upon approval of the District Court, which approval may be an adjustment method such as an annual percentage distribution if the percentage is not less than three percent (3%) nor more than five percent (5%) of the fair market value of the trust assets determined annually, and:*
1. *The amount distributable to a beneficiary of the estate is determined by reference to the income of the estate; and*
  2. *The personal representative determines, and after applying the rules of subsection (1) of Section 2 of this Act, that the personal representative is unable to comply with subsection (2) of Section 2 of this Act.*
- (4) *A fiduciary shall not make an adjustment:*
- (a) *That diminishes the income interest in a trust that requires all of the income to be paid at least annually to a spouse and for which an estate tax or gift tax marital deduction would be allowed, in whole or in part, if the fiduciary did not have the power to make the adjustment;*
  - (b) *That reduces the actuarial value of the income interest in a trust to which a person transfers property with the intent to qualify for a gift tax exclusion;*
  - (c) *That changes the amount payable to a beneficiary as a fixed annuity or a fixed fraction of the value of the trust assets;*
  - (d) *From any amount that is permanently set aside for charitable purposes under a will or the terms of a trust unless both income and principal are so set aside;*
  - (e) *If possessing or exercising the power to make an adjustment causes an individual to be treated as the owner of all or part of the trust or estate for income tax purposes, and the individual would not be treated as the owner if the fiduciary did not possess the power to make an adjustment;*
  - (f) *If possessing or exercising the power to make an adjustment causes all or part of the trust or estate assets to be included for estate tax purposes in the estate of an individual who has the power to remove a fiduciary, appoint a fiduciary, or both, and the assets would not be included in the estate of the individual if the fiduciary did not possess the power to make an adjustment;*
  - (g) *If the fiduciary is a beneficiary of the trust or estate; or*
  - (h) *If the fiduciary is not a beneficiary, but the adjustment would benefit the fiduciary directly or indirectly; except that any effect on the fiduciary's compensation shall not preclude an adjustment so long as the fiduciary's fees are reasonable and otherwise comply with the applicable law.*
- (5) *If paragraph (e), (f), (g), or (h) of subsection (4) of this section applies to a fiduciary and there is more than one (1) fiduciary, a cofiduciary to whom the provision shall not apply may make the adjustment unless the exercise of the power by the remaining fiduciary or fiduciaries is not permitted by the terms of the trust.*
- (6) *A fiduciary may release the entire power conferred by subsection (2) or (3) of this section or may release only the power to adjust from income to principal or the power to adjust*

*from principal to income if the fiduciary is uncertain about whether possessing or exercising the power will cause a result described in paragraphs (a) to (f) of subsection (4) of this section or paragraph (h) of subsection (4) of this section, or if the fiduciary 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 subsection (4) of this section. The release may be permanent or for a specified period, including a period measured by the life of an individual. Such release shall require approval of the District Court. Further, with approval of the District Court, a fiduciary may divide a trust into one (1) or more fractional shares if the division does not change the beneficial interests.*

- (7) *Terms of a trust or will that limit the power of a fiduciary to make an adjustment between principal and income do not affect the application of this section unless it is clear from the terms of the trust or will that the terms are intended to deny the fiduciary the power of adjustment conferred by subsection (2) or (3) of this section.*

## ARTICLE 2

### DECEDENT'S ESTATE OR TERMINATING INCOME INTEREST

SECTION 4. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

*After a decedent dies, in the case of an estate, or after an income interest in a trust ends, the following rules apply.*

- (1) *A fiduciary of an estate or of a terminating income interest shall determine the amount of net income and net principal receipts received from property specifically given to a beneficiary under the rules in Articles 3, 4, and 5 of the Kentucky Principal and Income Act that apply to trustees and the rules in subsection (5) of this section. The fiduciary shall distribute the net income and net principal receipts to the beneficiary who is to receive the specific property.*
- (2) *A fiduciary shall determine the remaining net income of a decedent's estate or a terminating income interest under the rules in Articles 3, 4, and 5 of the Kentucky Principal and Income Act that apply to trustees and by:*
- (a) *Including in net income all income from property used to discharge liabilities;*
  - (b) *Paying from income or principal, in the fiduciary's discretion, fees to attorneys, accountants, and fiduciaries; court costs and other expenses of administration; and interest on death taxes, but the fiduciary may pay those expenses from income of property passing to a trust for which the fiduciary claims an estate tax marital or charitable deduction only to the extent that the payment of those expenses from income will not cause the reduction or loss of the deduction; and*
  - (c) *Paying from principal all other disbursements made or incurred in connection with the settlement of a decedent's estate or the winding up of a terminating income interest, including debts, funeral expenses, disposition of remains, family allowances, and death taxes and related penalties that are apportioned to the estate or terminating income interest by the will, the terms of the trust, or applicable law.*
- (3) *A fiduciary shall distribute to a beneficiary who receives a pecuniary amount outright the interest or any other amount provided by the will, the terms of the trust, or applicable law from net income determined under subsection (2) of this section, or from principal to the*

*extent that net income is insufficient. If a beneficiary is to receive a pecuniary amount outright from a trust after an income interest ends and no interest or other amount is provided for by the terms of the trust or applicable law, the fiduciary shall distribute the interest or other amount to which the beneficiary would be entitled under applicable law if the pecuniary amount were required to be paid under a will.*

- (4) *A fiduciary shall distribute the net income remaining after distributions required by subsection (3) of this section in the manner described in Section 5 of this Act to all other beneficiaries, including a beneficiary who receives a pecuniary amount in trust, 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.*
- (5) *A fiduciary shall not reduce principal or income receipts from property described in subsection (1) of this section because of a payment described in Section 21 of this Act to the extent that the will, the terms of the trust, or applicable law requires the fiduciary to make the payment from assets other than the property or to the extent that the fiduciary recovers or expects to recover the payment from a third party. The net income and principal receipts from the property are determined by including all of the amounts the fiduciary receives or pays with respect to the property, whether those amounts accrued or became due before, on, or after the date of a decedent's death or an income interest's terminating event, and by making a reasonable provision for amounts that the fiduciary believes the estate or terminating income interest may become obligated to pay after the property is distributed.*

SECTION 5. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

- (1) *Each beneficiary described in subsection (4) of Section 4 of this Act is entitled to receive a portion of the net income equal to the beneficiary's fractional interest in undistributed principal assets, using values as of the distribution date. If a fiduciary makes more than one (1) distribution of assets to beneficiaries to whom this section applies, each beneficiary, including one (1) who shall not receive part of the distribution, is entitled, as of each distribution date, to the net income the fiduciary has received after the date of the death or terminating event or earlier distribution date but has not distributed as of the current distribution date.*
- (2) *In determining a beneficiary's share of net income, the following rules apply.*
  - (a) *The beneficiary is entitled to receive a portion of the net income equal to the beneficiary's fractional interest in the undistributed principal assets immediately before the distribution date, including assets that later may be sold to meet principal obligations.*
  - (b) *The beneficiary's fractional interest in the undistributed principal assets shall be calculated without regard to property specifically given to a beneficiary and property required to pay pecuniary amounts not in trust.*
  - (c) *The beneficiary's fractional interest in the undistributed principal assets shall be calculated on the basis of the aggregate value of those assets as of the distribution date without reducing the value by an unpaid principal obligation.*
  - (d) *The distribution date for purposes of this section may be the date as of which the fiduciary calculates the value of the assets if that date is reasonably near the date on which assets are actually distributed.*

- (3) *If a fiduciary does not distribute all of the collected but undistributed net income to each person as of a distribution date, the fiduciary shall maintain appropriate records showing the interest of each beneficiary in that net income.*
- (4) *A fiduciary may apply the rules in this section, to the extent that the fiduciary considers it appropriate, to net gain or loss realized after the date of death or terminating event or earlier distribution date from the disposition of a principal asset if this section applies to the income from the asset.*

### ARTICLE 3

#### APPORTIONMENT AT BEGINNING

#### AND END OF INCOME INTEREST

SECTION 6. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

- (1) *An income beneficiary is entitled to net income from the date on which the income interest begins. An income interest begins on the date specified in the terms of the trust or, if no date is specified, on the date an asset becomes subject to a trust or successive income interest.*
- (2) *An asset becomes subject to a trust:*
  - (a) *On the date it is transferred to the trust in the case of an asset that is transferred to a trust during the transferor's life;*
  - (b) *On the date of a testator's death in the case of an asset that becomes subject to a trust by reason of a will, even if there is an intervening period of administration of the testator's estate; or*
  - (c) *On the date of an individual's death in the case of an asset that is transferred to a fiduciary by a third party because of the individual's death.*
- (3) *An asset becomes subject to a successive income interest on the day after the preceding income interest ends, as determined under subsection (4) of this section, even if there is an intervening period of administration to wind up the preceding income interest.*
- (4) *An income interest ends on the day before an income beneficiary dies or another terminating event occurs, or on the last day of a period during which there is no beneficiary to whom a trustee may distribute income.*

SECTION 7. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

- (1) *A trustee shall allocate an income receipt or disbursement other than one to which subsection (1) of Section 4 of this Act applies to principal if its due date occurs before a decedent dies in the case of an estate or before an income interest begins in the case of a trust or successive income interest.*
- (2) *A trustee shall allocate an income receipt or disbursement to income if its due date occurs on or after the date on which a decedent dies or an income interest begins and it is a periodic due date. An income receipt or disbursement shall be treated as accruing from day to day if its due date is not periodic or it has no due date. The portion of the receipt or disbursement accruing before the date on which a decedent dies or an income interest begins shall be allocated to principal and the balance shall be allocated to income.*

- (3) *An item of income or an obligation is due on the date the payer is required to make a payment. If a payment date is not stated, there is no due date for the purposes of Sections 1 to 27 of this Act. Distributions to shareholders or other owners from an entity to which Section 9 of this Act applies are deemed to be due on the date fixed by the entity for determining who is entitled to receive the distribution or, if no date is fixed, on the declaration date for the distribution. A due date is periodic for receipts or disbursements that shall be paid at regular intervals under a lease or an obligation to pay interest or if an entity customarily makes distributions at regular intervals.*

SECTION 8. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

- (1) *In this section, "undistributed income" means net income received before the date on which an income interest ends. The term shall not include an item of income or expense that is due or accrued or net income that has been added or is required to be added to principal under the terms of the trust.*
- (2) *When a mandatory income interest ends, the trustee shall pay to a mandatory income beneficiary who survives that date, or the estate of a deceased mandatory income beneficiary whose death causes the interest to end, the beneficiary's share of the undistributed income that is not disposed of under the terms of the trust unless the beneficiary has an unqualified power to revoke more than five percent (5%) of the trust immediately before the income interest ends. In the latter case, the undistributed income from the portion of the trust that may be revoked shall be added to principal.*
- (3) *When a trustee's obligation to pay a fixed annuity or a fixed fraction of the value of the trust's assets ends, the trustee shall prorate the final payment if and to the extent required by applicable law to accomplish a purpose of the trust or its settlor relating to income, gift, estate, or other tax requirements. The settlor may change the charitable beneficiary of a trust by Will or through written notice to trustee, or may decline to make a change in like manner, so long as the change does not alter the income, gift, estate, or other tax benefits available under the terms of the trust.*

#### ARTICLE 4

#### ALLOCATION OF RECEIPTS

#### DURING ADMINISTRATION OF TRUST

SECTION 9. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

- (1) *In this section, "entity" means a corporation, partnership, limited liability company, regulated investment company, real estate investment trust, common trust fund, or any other organization in which a trustee has an interest other than a trust or estate to which Section 10 of this Act applies.*
- (2) *Except as otherwise provided in this section, a trustee shall allocate to income money received from an entity.*
- (3) *A trustee shall allocate the following receipts from an entity to principal:*
- (a) *Property other than money;*
  - (b) *Money received in one (1) distribution or a series of related distributions in exchange for part or all of a trust's interest in the entity;*

- (c) *Money received in total or partial liquidation of the entity; and*
  - (d) *Money received from an entity that is a regulated investment company or a real estate investment trust, if the money distributed is a capital gain dividend for federal income tax purposes.*
- (4) *Money is received in partial liquidation:*
- (a) *To extent that the entity, at or near the time of a distribution, indicates that it is a distribution in partial liquidation; or*
  - (b) *If the total amount of money and property received in a distribution or series of related distributions is greater than twenty percent (20%) of the entity's gross assets, as shown by the entity's year end financial statements immediately preceding the initial receipt.*
- (5) *Money is not received in partial liquidation, nor may it be taken into account under paragraph (b) of subsection (4) of this section to the extent that it does not exceed the amount of income that a trustee or beneficiary shall pay on taxable income of the entity that distributes the money.*
- (6) *A trustee may rely upon a statement made by an entity about the source or character of a distribution if the statement is made at or near the time of distribution by the entity's board of directors or other person or group of persons authorized to exercise powers to pay money or transfer property comparable to those of a corporation's board of directors.*

SECTION 10. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

*A trustee shall allocate to income an amount received as a distribution of income from a trust or an estate in which the trust has an interest other than a purchased interest, and shall allocate to principal an amount received as a distribution of principal from such a trust or estate. If a trustee purchases an interest in a trust that is an investment entity, or a decedent or donor transfers an interest in such a trust to a trustee, Section 9 of this Act applies to a receipt from the trust.*

SECTION 11. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

*A trustee shall allocate to principal:*

- (1) *To the extent not allocated to income under Sections 1 to 27 of this Act, assets received from a transferor during the transferor's lifetime, a decedent's estate, a trust with a terminating income interest, or a payer under a contract naming the trust or its trustee as beneficiary;*
- (2) *Money or other property received from the sale, exchange, liquidation, or change in form of a principal asset, including stock splits and realized profit, subject to this article;*
- (3) *Amounts recovered from third parties to reimburse the trust because of disbursements described in subsection (1)(g) of Section 22 of this Act or for other reasons to the extent not based on the loss of income;*
- (4) *Proceeds of property taken by eminent domain, but a separate award made for the loss of income with respect to an accounting period during which a current income beneficiary had a mandatory income interest is income;*



- (5) *Net income received in an accounting period during which there is no beneficiary to whom a trustee may or shall distribute income;*
- (6) *If a trustee grants an option to buy property from the trust, whether or not the trust owns the property when the option is granted, grants an option that permits another person to sell property to the trust, or acquires an option to buy property for the trust or an option to sell an asset owned by the trust, and the trustee or other owner of the asset is required to deliver the asset if the option is exercised, an amount received for granting the option shall be allocated to principal. An amount paid to acquire the option shall be paid from principal. A gain or loss realized upon the exercise of an option, including an option granted to a settlor of the trust for services rendered, shall be allocated to principal; and*
- (7) *Other receipts as provided in Sections 15, 16, 17, 18, 19, and 20 of this Act.*

SECTION 12. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

*To the extent that a trustee accounts for receipts from rental property under this section, the trustee shall allocate to income an amount received as rent of real or personal property, including an amount received for cancellation or renewal of a lease. An amount received as a refundable deposit, including a security deposit or a deposit that is applied as rent for future periods, shall be added to principal and held subject to the terms of the lease and is not available for distribution to a beneficiary until the trustee's contractual obligations have been satisfied with respect to that amount.*

SECTION 13. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

- (1) *An amount received as interest, whether determined at a fixed, variable, or floating rate, on an obligation to pay money to the trustee, including an amount received as consideration for prepaying principal, shall be allocated to income without any provision for amortization of premium.*
- (2) *A trustee shall allocate to principal an amount received from the sale, redemption, or other disposition of an obligation to pay money to the trustee more than one (1) year after it is purchased or acquired by the trustee, including an obligation whose purchase price or value when it is acquired is less than its value at maturity. If the obligation matures within one (1) year after it is purchased or acquired by the trustee, an amount received in excess of its purchase price or its value when acquired by the trust shall be allocated to income.*
- (3) *This section shall not apply to an obligation to which Section 12, 16, 17, 18, or 19 of this Act applies.*

SECTION 14. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

- (1) *Except as otherwise provided in subsection (2) of this section, a trustee shall allocate to principal the proceeds of a life insurance policy or other contract in which the trust or its trustee is named as beneficiary, including a contract that insures the trust or its trustee against loss for damage to, destruction of, or loss of title to a trust asset. The trustee shall allocate dividends on an insurance policy to income if the premiums on the policy are paid from income, and to principal if the premiums are paid from principal.*

- (2) *A trustee shall allocate to income proceeds of a contract that insures the trustee against loss of occupancy or other use by an income beneficiary, loss of income, or loss of profits from a business.*
- (3) *This section shall not apply to a contract to which Section 16 of this Act applies.*

SECTION 15. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

*If a trustee determines that an allocation between principal and income required by Section 16, 17, 18, or 19 of this Act is unsubstantial, the trustee may allocate the entire amount to principal unless one (1) of the circumstances described in subsection (4) of Section 3 of this Act applies to the allocation. This power may be exercised by a cotrustee in the circumstances described in subsection (4) of Section 3 of this Act and may be released for the reasons and in the manner described in subsection (6) of Section 3 of this Act. An allocation is presumed to be insubstantial if:*

- (1) *The amount of the allocation would increase or decrease net income in an accounting period, as determined before the allocation, by less than ten percent (10%); or*
- (2) *The value of the asset producing the receipt for which the allocation would be made is less than ten percent (10%) of the total value of the trust's assets at the beginning of the accounting period.*

SECTION 16. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

- (1) *In this section, "payment" means a payment that a trustee may receive over a fixed number of years or during the life of one (1) or more individuals because of services rendered or property transferred to the payer in exchange for future payments. The term includes a payment made in money or property from the payer's general assets or from a separate fund created by the payer, including a private or commercial annuity, an individual retirement account, and a pension, profit-sharing, stock-bonus, or stock-ownership plan.*
- (2) *To the extent that a payment is characterized as interest or a dividend or a payment made in lieu of interest or a dividend, a trustee shall allocate it to income. The trustee shall allocate to principal the balance of the payment and any other payment received in the same accounting period that is not characterized as interest, a dividend, or an equivalent payment.*
- (3) *If no part of a payment is characterized as interest, a dividend, or an equivalent payment and all or part of the payment is required to be made, a trustee shall allocate to income ten percent (10%) of the part that is required to be made during the accounting period and the balance to principal. If no part of a payment is required to be made or the payment received is the entire amount to which the trustee is entitled, the trustee shall allocate the entire payment to principal. For purposes of this subsection, a payment is not "required to be made" to the extent that it is made because the trustee exercises a right of withdrawal.*
- (4) *If, to obtain an estate tax marital deduction for a trust, a trustee shall allocate more of a payment to income than provided for by this section, the trustee shall allocate to income the additional amount necessary to obtain the marital deduction.*
- (5) *This section shall not apply to payments to which Section 17 of this Act applies.*

SECTION 17. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

- (1) *In this section, "liquidating asset" means an asset whose value will diminish or terminate because the asset is expected to produce receipts for a period of limited duration. The term includes a leasehold, patent, copyright, royalty right, and right to receive payments during a period of more than one (1) year under an arrangement that shall not provide for the payment of interest on the unpaid balance. The term shall not include an activity subject to Section 11(6) of this Act, payment subject to Section 16 of this Act, resources subject to Section 18 of this Act, timber subject to Section 19 of this Act, or any asset for which the trustee establishes a reserve for depreciation under Section 23 of this Act.*
- (2) *A trustee shall allocate to income ten percent (10%) of the receipts from a liquidating asset and the balance to principal.*

SECTION 18. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

- (1) *To the extent that a trustee accounts for receipts from an interest in minerals or other natural resources pursuant to this section, the trustee shall allocate them as follows:*
  - (a) *If received as nominal delay rental or nominal annual rent on a lease, a receipt shall be allocated to income;*
  - (b) *If received from a production payment, a receipt shall be allocated to income if and to the extent that the agreement creating the production payment provides a factor for interest or its equivalent. The balance shall be allocated to principal;*
  - (c) *If an amount received as a royalty, shut-in-well payment, take-or-pay payment, bonus, or delay rental is more than nominal, ninety percent (90%) shall be allocated to principal and the balance to income; or*
  - (d) *If an amount is received from a working interest or any other interest not provided for in paragraph (a), (b), or (c) of this subsection, ninety percent (90%) of the net amount received shall be allocated to principal and the balance to income.*
- (2) *An amount received on account of an interest in water that is renewable shall be allocated to income. If the water is not renewable, ninety percent (90%) of the amount shall be allocated to principal and the balance to income.*
- (3) *Sections 1 to 27 of this Act apply whether or not a decedent or donor was extracting minerals, water, or other natural resources before the interest became subject to the trust.*
- (4) *If a trust owns an interest in minerals, water, or other natural resources on the effective date of this Act, the trustee may allocate receipts from the interest as provided in Sections 1 to 27 of this Act or in the manner used by the trustee before the effective date of this Act. If the trust acquires an interest in minerals, water, or other natural resources after the effective date of this Act, the trustee shall allocate receipts from the interest as provided in Sections 1 to 27 of this Act.*
- (5) *The proceeds from any disposition of an interest specified in this section shall be allocated in the same manner as receipts from the interest.*

SECTION 19. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

- (1) *To the extent that a trustee accounts for receipts from the sale of timber and related products pursuant to this section, the trustee shall allocate the net receipts:
 
  - (a) *To income to the extent that the amount of timber removed from the land does not exceed the rate of growth of the timber during the accounting periods in which a beneficiary has a mandatory income interest;*
  - (b) *To principal to the extent that the amount of timber removed from the land exceeds the rate of growth of the timber or the net receipts are from the sale of standing timber;*
  - (c) *To or between income and principal if the net receipts are from the lease of timberland or from a contract to cut timber from land owned by a trust, by determining the amount of timber removed from the land under the lease or contract and applying the rules in paragraphs (a) and (b) of this subsection; or*
  - (d) *To principal to the extent that advance payments, bonuses, and other payments are not allocated pursuant to paragraphs (a), (b), or (c) of this subsection.**
- (2) *In determining net receipts allocated under subsection (1) of this section, a trustee shall deduct and transfer to principal a reasonable amount for depletion.*
- (3) *Sections 1 to 27 of this Act apply whether or not a decedent or transferor was harvesting timber from the property before it became subject to the trust.*
- (4) *If a trust owns an interest in timberland on the effective date of this Act, the trustee may allocate net receipts from the sale of timber and related products as provided in Sections 1 to 27 of this Act or in the manner used by the trustee before the effective date of this Act. If the trust acquires an interest in timberland after the effective date of this Act, the trustee shall allocate net receipts from the sale of timber and related products as provided in Sections 1 to 27 of this Act.*

SECTION 20. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

- (1) *If a marital deduction is allowed for all or part of a trust, the spouse may require the trustee to make the trust income productive.*
- (2) *In cases not governed by subsection (1) of this section, proceeds from the sale or other disposition of an asset are principal without regard to the amount of income the asset produces during any accounting period.*

#### ARTICLE 5

#### ALLOCATION OF DISBURSEMENTS DURING ADMINISTRATION OF TRUST

SECTION 21. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

*A trustee shall make the following disbursements from income to the extent that they are not disbursements to which subsection (2)(b) or (2)(c) of Section 4 of this Act applies:*

- (1) *One-half (1/2) of the regular compensation of the trustee and of any person providing investment advisory or custodial services to the trustee, except as provided in KRS 386.180;*

- (2) *One-half (1/2) of all expenses for accountings, judicial proceedings, or other matters that involve both the income and remainder interests;*
- (3) *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*
- (4) *Recurring premiums on insurance covering the loss of a principal asset or the loss of income from or use of the asset.*

SECTION 22. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

- (1) *A trustee shall make the following disbursements from principal:*
  - (a) *That portion of the regular compensation of the trustee and any person providing investment advisory or custodial services to the trustee not paid from income under subsection (1) of Section 21 of this Act;*
  - (b) *The remaining one-half (1/2) of the disbursements described in subsection (2) of Section 21 of this Act;*
  - (c) *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;*
  - (d) *Payments on the principal of a trust debt;*
  - (e) *Expenses of a proceeding that concerns primarily principal, including a proceeding to construe the trust or to protect the trust or its property;*
  - (f) *Premiums paid on a policy of insurance not described in subsection (4) of Section 21 of this Act of which the trust is the owner and beneficiary;*
  - (g) *Estate, inheritance, and other transfer taxes, including penalties, apportioned to the trust; and*
  - (h) *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.*

SECTION 23. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

- (1) *In 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 (1) 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 shall 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; or*
  - (b) *During the administration of a decedent's estate.*
- (3) *An amount transferred to principal need not be held as a separate fund.*

SECTION 24. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

- (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 (1) or more accounting periods to reimburse principal or to provide a reserve for future principal disbursements.*
- (2) *Principal disbursements to which subsection (1) of this section applies 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 subsection (1)(g) of Section 22 of this Act.*
- (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.*

SECTION 25. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

- (1) *A tax required to be paid by a trustee based on receipts allocated to income shall be paid from income.*
- (2) *A tax required to be paid by a trustee based on receipts allocated to principal shall 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 shall be paid proportionately:*
- (a) *From income to the extent that receipts from the entity are allocated to income; and*
  - (b) *From principal to the extent that:*
    - 1. *Receipts from the entity are allocated to principal; and*

2. *The trust's share of the entity's taxable income exceeds the total receipts described in paragraph (a) of this subsection and paragraph (b)1. of this subsection.*
- (4) *For purposes of this section, receipts allocated to principal or income shall be reduced by the amount distributed to a beneficiary from principal or income for which the trust receives a deduction in calculating the tax.*

SECTION 26. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

- (1) *A fiduciary may, with District Court approval, make adjustments between principal and income to offset the shifting of economic interests or tax benefits between income beneficiaries and remainder beneficiaries which 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 shall 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 shall be the same as its proportionate share of the total decrease in income tax. An estate or trust shall reimburse principal from income.*

SECTION 27. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

- (1) *The provisions of Section 3 of this Act that allow a trustee to adopt the prudent investor rule and make allocations to income shall not apply to any trust without District Court approval.*
- (2) *The provisions of Sections 1 to 27 of this Act, other than Section 3 of this Act, shall apply to all trusts administered under Kentucky law, except as otherwise specifically provided in the instrument creating the trust, regardless of when created.*

## ARTICLE 6

### MISCELLANEOUS PROVISION

SECTION 28. A NEW SECTION OF KRS CHAPTER 386 IS CREATED TO READ AS FOLLOWS:

*Sections 1 to 27 of this Act may be cited as the " Kentucky Principal and Income Act."*

SECTION 29. The following KRS sections are repealed:

- 386.191 Definitions for KRS 386.191 to 386.349.
- 386.195 Rules of trust administration.
- 386.205 Definition of income and principal.
- 386.215 Income interest -- Income beneficiary.
- 386.225 Determination and distribution of income.
- 386.235 Corporate distribution of shares.
- 386.245 Corporate securities.
- 386.255 Net profits of business.
- 386.265 Royalties and other receipts from disposition of natural resources.
- 386.275 Timber.
- 386.285 Other depletable property.
- 386.295 Delayed income from sale of underproductive property.
- 386.305 Charges against income.
- 386.315 Apportionment of expenses.
- 386.325 Application of KRS 386.191 to 386.459.
- 386.335 Construction of KRS 386.191 to 386.349.
- 386.345 Effective date -- Application on receipts and expenses.
- 386.349 Short title.

Section 30. This Act takes effect January 1, 2005.

**Approved April 22, 2004**