

Memorandum 99-40

1999 Legislative Program: AB 846 — Uniform Principal and Income Act

Assembly Bill 846, the Commission's version of the Uniform Principal and Income Act of 1997, has passed the Assembly and will be heard in the Senate Judiciary Committee on June 29th. This memorandum submits a handful of additional amendments and Comment revisions for Commission approval.

Some technical amendments have been made since the Commission last reviewed the bill at the April meeting. All the statutory and Comment revisions are technical — some of them are in response to the letter from David W. Lauer, on behalf of the California Bankers Association (Exhibit pp. 1-2), and others result from further staff review. In a conference call on June 2, the staff and CBA representatives discussed the points raised in the letter and came to the consensus reflected in the revisions set out in the Exhibit at pp. 3-6. The revisions are discussed in the Staff Notes following each section.

Due to legislative schedules and the need to provide relevant information to the Senate Judiciary Committee consultant who is working on AB 846, these draft revised Comments (labeled as such) have been provided to the consultant. If the Commission decides to make any changes, we will forward them to the consultant at the earliest opportunity.

There may be further suggestions from CBA and the State Bar Estate Planning, Trust and Probate Law Section Executive Committee for revisions in the Comment language. If the staff receives any more suggestions, we will include them in a supplement. However, we believe that the revision process should soon come to an end.

Respectfully submitted,

Stan Ulrich
Assistant Executive Secretary

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May 5, 1999

Mr. Stan Ulrich
California Law Revision Commission
4000 Middlefield Road, Room D-1
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Re: Proposed Uniform Principal and Income Act

Dear Stan:

As we discussed yesterday, the California Bankers Association Trust Governmental Affairs Committee has reviewed the language and comments contained in your e-mail dated March 22, 1999. The Committee has also further reviewed the proposal and is offering certain technical comments.

The following are concerns which the Committee has with respect to the proposal contained in your e-mail concerning the adjustment power.

- 1.) We suggest changes to the proposed Section 16336 Subdivision (g). The phrase "under this section" should be deleted. In addition, the last sentence should be rewritten to read "A trustee is not liable for not considering whether to make an adjustment or choosing not to make an adjustment."

We find the last section of the expanded comments not to be relevant or helpful and recommend that it be deleted, beginning with, "This rule is a corollary....," and ending with, "...impartially (Section 16003)."

- 2.) In the new Section 16338, the phrase, "under section 17200" should be deleted.

In the last sentence of the Comment to the new Section 16338, the phrase "the proper level of," should be replaced with, "a trustee's exercise or nonexercise of the power to make an adjustment, or the proper level of adjustment, if any."

- 3.) As we discussed, the Committee has a concern regarding any power to adjust being applicable to trusts where the trustee is legally limited to paying interest only to beneficiaries. We recommend strongly that the power to adjust be made specifically inapplicable to these trusts.

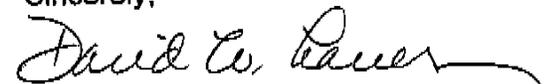
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Please note the Committee's concerns of a technical nature with other sections of the proposed statute:

- 1.) Article 5.1 should contain a reference to the administration of estates as well as trusts.
- 2.) Section 16350(d)(2) should be deleted. The Section is unduly burdensome and impossible to comply with since a trustee will not necessarily know the relevant tax bracket of the beneficiary, who is not required to provide such information to a trustee.
- 3.) As we have previously noted, Section 16360 should be deleted. It is inappropriate to create an arbitrary standard of what is insubstantial. Allocations should be made consistent with other provisions of the Act.
- 4.) Leasehold interests should be deleted from Section 16362. It appears not to be appropriate to included leasehold interests among liquidating assets.
- 5.) The first sentence of 16372(b) should be amended to read "A trustee may, but is not required to, transfer from income to principal..." This addition is consistent with the concept of the current Probate Code Section 16313, which should be retained.

I look forward to reviewing these comments with you at the earliest time. Based on our discussion yesterday, we anticipate that we can reach agreement on the final version of the proposed statute.

Sincerely,



bcc: Paulette Leahy
Jim Bessolo
Phyllis Siegel
Maurine Padden

June 14, 1999

**DRAFT REPORT OF THE
CALIFORNIA LAW REVISION COMMISSION
ON ASSEMBLY BILL 846**

Uniform Principal and Income Act

Assembly Bill 846, authored by Assemblyman Dick Ackerman, implements the California Law Revision Commission recommendation on the *Uniform Principal and Income Act*, 29 Cal. L. Revision Comm'n Reports 245 (1999). The new and revised Comments set out below supersede the comparable Comments in the recommendation and reflect amendments to the bill made during the legislative process.

☞ **Staff Note.** The paragraph above is the Commission's standard form for transmitting new and revised Comments. The statutory language with revisions since the printed recommendation was prepared is included below so that you can see the statutory language together with the revised Comments.

§ 16336. Trustee's power to adjust [see UPAIA § 104]

16336. (a) Subject to subdivision (b), a trustee may make an adjustment between principal and income to the extent the trustee considers necessary if all of the following conditions are satisfied:

- (1) The trustee invests and manages trust assets under the prudent investor rule.
- (2) The trust describes the amount that shall or may be distributed to a beneficiary by referring to the trust's income.
- (3) The trustee determines, after applying the rules in subdivision (a) of Section 16335, and considering any power the trustee may have under the trust to invade principal or accumulate income, that the trustee is unable to comply with subdivision (b) of Section 16335.

(b) A trustee may not make an adjustment between principal and income in any of the following circumstances:

- (1) Where it would diminish the income interest in a trust that (A) requires all of the income to be paid at least annually to a spouse and (B) for which, if the trustee did not have the power to make the adjustment, an estate tax or gift tax marital deduction would be allowed, in whole or in part.
- (2) Where it would reduce 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.
- (3) Where it would change the amount payable to a beneficiary as a fixed annuity or a fixed fraction of the value of the trust assets.
- (4) From any amount that is permanently set aside for charitable purposes under a will or trust, unless both income and principal are so set aside.
- (5) Where possessing or exercising the power to make an adjustment would cause an individual to be treated as the owner of all or part of the trust for income

tax purposes, and the individual would not be treated as the owner if the trustee did not possess the power to make an adjustment.

(6) Where possessing or exercising the power to make an adjustment would cause all or part of the trust assets to be included for estate tax purposes in the estate of an individual who has the power to remove a trustee or appoint a trustee, or both, and the assets would not be included in the estate of the individual if the trustee did not possess the power to make an adjustment.

(7) Where the trustee is a beneficiary of the trust.

(c) Notwithstanding Section 15620, if paragraph (5), (6), or (7) of subdivision (b) applies to a trustee and there is more than one trustee, a cotrustee to whom the provision does not apply may make the adjustment unless the exercise of the power by the remaining trustee or trustees is not permitted by the trust.

(d) A trustee may release the entire power conferred by subsection (a) or may release only the power to adjust from income to principal or the power to adjust from principal to income in either of the following circumstances:

(1) If the trustee is uncertain about whether possessing or exercising the power will cause a result described in paragraphs (1) to (6), inclusive, of subdivision (b).

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

(e) A release under subdivision (d) may be permanent or for a specified period, including a period measured by the life of an individual.

(f) A trust that limits the power of a trustee to make an adjustment between principal and income does not affect the application of this section unless it is clear from the trust that it is intended to deny the trustee the power of adjustment provided by subsection (a).

(g) Nothing in this section or in this chapter is intended to create or imply a duty to make an adjustment, and a trustee is not liable for not considering whether to make an adjustment or for choosing not to make an adjustment.

Comment. Section 16336 is the same as parts of drawn in part from Section 104 of the Uniform Principal and Income Act (1997). The purpose of this section is to provide a way to reconcile the tension between the duties under the Uniform Prudent Investor Act (Section 16045 *et seq.*) and the technical trust accounting rules governing allocations between principal and income provided in other parts of this chapter, the Uniform Principal and Income Act. The power to adjust is a discretionary power and is subject to rules governing exercise of discretionary powers, both under the trust terms and the law of trusts. The trustee may exercise the power to adjust under the authority of this section and related rules, or may prefer to seek the agreement of beneficiaries before making the adjustment. A procedure for giving notice of proposed actions is provided in Section 16337. The trustee may also seek court approval under Section 17200(b)(5) of a decision to make an adjustment. Subdivision (g) reaffirms and expands on the portion of subdivision (a) providing that the trustee may make an adjustment to the extent the trustee considers necessary. Subdivision (g) makes clear that the existence of the adjustment power does not create or imply a duty to use it. The trustee may, without liability, decide as an institutional policy or with respect to individual trusts or classes of trusts, whether and under what conditions it will use the adjustment power. This rule is a corollary of the principle stated in Section 16202 that the grant of a power does not authorize its use and that exercise of a power is subject to

fiduciary duties. Subdivision (g) does not affect any liability that may result from breach of a duty under other trust law.

The condition expressed in subdivision (a)(1) — that the trustee invests and manages trust assets under the prudent investor rule — will almost always be met. The Uniform Prudent Investor Act (Sections 16045-16054) applies to all California trusts, except to the extent a trust provides otherwise. See Sections 16046(b) (control by trust instrument), 16054 (application of prudent investor rule to all trusts). Under Section 16046, even where the trust provides special rules, to the extent the rules can be classed as a prudent investor rule, the condition of subdivision (a)(1) is satisfied.

The trustee's determination of whether to make an adjustment under this section, and how to implement the adjustment, are subject to the trustee's fiduciary duties. See Sections 16003, 16335(b). Unlike Section 104(b) of the Uniform Principal and Income Act (1997), this section does not mandate consideration of particular factors, but the UPAIA factors provide useful guidance. Thus, in deciding whether and to what extent to exercise the power to make adjustments under subsection (a), the following factors are appropriate to consider: (1) the nature, purpose, and expected duration of the trust; (2) the intent of the settlor; (3) the identity and circumstances of the beneficiaries; (4) the needs for liquidity, regularity of income, and preservation and appreciation of capital; (5) the assets held in the trust; the extent to which they consist of financial assets, interests in closely held enterprises, tangible and intangible personal property, or real property; the extent to which an asset is used by a beneficiary; and whether an asset was purchased by the trustee or received from the settlor; (6) the net amount allocated to income under other sections and the increase or decrease in the value of the principal assets, which the trustee may estimate as to assets for which market values are not readily available; (7) whether and to what extent the trust gives the trustee the power to invade principal or accumulate income or prohibit the trustee from invading principal or accumulating income, and the extent to which the trustee has exercised a power from time to time to invade principal or accumulate income; (8) the actual and anticipated effect of economic conditions on principal and income and effects of inflation and deflation; and (9) the anticipated tax consequences of an adjustment.

The introductory clause in subdivision (c) recognizes that this subdivision is an exception to the default rule requiring trustees to act unanimously.

See also Sections 24 ("beneficiary" defined), 84 ("trustee" defined), 16324 ("income" defined).

☞ **Staff Note.** The intent of the statutory language in subdivision (g) and the amplification in the first paragraph of the Comment is to make clear that the existence of the power to adjust is a neutral factor. We have had some difficulty drafting language that everyone working on this project agrees is neutral. The staff believes this language accomplishes the purpose without saying too little or too much.

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§ 16338. Remedy in proceedings concerning adjustment

16338. In a proceeding under ~~Section 17200~~ with respect to a trustee's exercise or nonexercise of the power to make an adjustment under Section 16336, the sole remedy is to direct, deny, or revise an adjustment between principal and income.

Comment. Section 16338 limits the remedy in proceedings concerning adjustments under Section 16336 to correcting the adjustment. This rule recognizes that if there is a dispute concerning exercise of the adjustment power, it is between the affected beneficiaries, and not between the trustee and beneficiaries. Accordingly, the trustee is not liable for a surcharge or denial of fees where the dispute relates to the exercise or nonexercise of the power to adjust or the proper level of an adjustment, if any.

☞ **Staff Note.** The May 5 CBA letter requested this change. While the staff believes all proceedings will be under the judicial review provisions commencing with Section 17200, removal of the language does not cause any problems.

§ 16339. Application of chapter to existing trusts and estates [UPAIA § 605]

16339. This chapter applies to every trust or decedent's estate existing on or after January 1, 2000, except as otherwise expressly provided in the trust or will or in this chapter.

Comment. Section 16339 is the same in substance as Section 605 of the Uniform Principal and Income Act (1997).

See also Section 3 (general transitional provisions).

☞ **Staff Note.** The “or after” language is added to make clear that the new law applies prospectively as well as to existing trusts.

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§ 16372. Transfers from income to principal for depreciation [UPAIA § 503]

16372. (a) 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.

(b) A trustee may transfer from income to principal a reasonable amount of the net cash receipts from a principal asset that is subject to depreciation, under generally accepted accounting principles, but may not transfer any amount for depreciation under this section in any of the following circumstances:

(1) As to the 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.

(2) During the administration of a decedent's estate.

(3) If the trustee is accounting under Section 16352 for the business or activity in which the asset is used.

(c) An amount transferred from income to principal need not be held as a separate fund.

Comment. Section 16372 supersedes former Section 16313 and is the same as Section 503 of the Uniform Principal and Income Act (1997), with some clarifying language and the addition of the generally accepted accounting principles standard in subdivision (b). This addition continues the substance of former Section 16312(b)(2). Section 16372 also supersedes the last part of former Section 16312(d)(3). The word “may” in subdivision (b) has the same meaning as the phrase “is not required to” in former Section 16313.

See also Sections 84 (“trustee” defined), 16324 (“income” defined).

☞ **Staff Note.** The sentence added to the Comment resolves a concern expressed in the May 5 CBA letter.