

Memorandum 99-25

Uniform Principal and Income Act: Proposed Amendments to AB 846

We believe that agreement has been reached on a number of amendments to resolve the California Bankers Association's concerns with the Commission's recommendation on the *Uniform Principal and Income Act* (UPAIA). Assemblyman Dick Ackerman is carrying the bill to implement the recommendation (AB 846). The bill has been referred to the Assembly Judiciary Committee. If the Commission approves the proposed amendments, we will get the bill amended before it is heard.

At the request of CBA representatives, James Deeringer (liaison with the State Bar Estate Planning, Trust and Probate Law Section Executive Committee), Matthew Rae, Jr. (representing the California Uniform Laws Commission), and I (Stan Ulrich) met on March 19th with the CBA Trust State Governmental Relations Committee: David Lauer (Wells Fargo), James Bessolo (Bank of America), Paulette Leahy (Union Bank), Phyllis Siegel (Sanwa Bank), and Maurine Padden (CBA lobbyist).

CBA's primary concern is with anticipated administrative problems in applying a new law to a large number of existing trusts. The UPAIA power to make adjustments between principal and income accounts in a limited number of trusts will lead, they believe, to expensive and burdensome litigation. In addition, trustees will need to review existing trusts to see whether they are appropriate for application of the adjustment power.

The focus of those of us speaking for the UPAIA is on the fundamental problem addressed by the adjustment power in proposed Section 16336. There are cases where a trustee who is investing for total return in fulfillment of duties under the Uniform Prudent Investor Act (Prob. Code § 16047) will not produce adequate trust accounting income for the income beneficiaries. The adjustment power permits the trustee to satisfy the duty of impartiality and the duty to make the trust productive under prudent investor rules. Our goal has been to craft rules and procedures that address the administrative and liability concerns

expressed by CBA while preserving the utility of the adjustment power to resolve conflicts between countervailing duties that govern trustees.

Some steps had been approved by the Commission over the past year, in response to suggestions from the Working Group, which had met on four occasions to address these issues. Consequently, the recommendation included a number of ameliorating revisions. The list of mandatory factors in Section 104 of the uniform act to be considered in determining whether and how much to adjust — which some had termed “litigation points” — was removed from the statutory language of Section 16336 and placed in the Comment as advisory, nonmandatory guidelines. A simple and efficient procedure for giving notice of proposed action under the UPAIA was added to the statute (Section 16337).

The following amendments continue the process of clarifying how the adjustment power is used and reducing the administrative problems for trustees in implementing the new statute:

1. Relationship of Power To Invade Principal

Section 16336(a)(3) should be amended to refer to the potential role the trustee’s power to invade principal has to play in applying the preconditions to the power to adjust. The group’s consensus is to revise this provision as follows (the full text of Section 16336 with proposed revisions is in the Exhibit):

(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.

The CBA had suggested at earlier Commission meetings that the power to adjust should not apply where the trustee has the power to invade principal. The staff and other commentators felt this proposal went too far, since a power to invade should supplant a power to adjust only to the extent that the same goal can be reached. The language added to Section 16336(a)(3) is intended to make clear in the statute that the trustee should first consider a power to invade principal in the trust instrument. In order to take account of economic conditions where income exceeds capital growth, leading to an overproduction of trust accounting income, the new language should also refer to the opposite power to accumulate income.

2. Exercise of Power To Adjust Is Fully Discretionary

Section 16336 should be amended to make clear that the existence of the power to adjust does not create a duty and that a trustee is not liable for not exercising the power to adjust. It is understood that this does not have any effect on any liability that may arise for failure to comply with the prudent investor rule or breach of the duty of impartiality.

This clarification would be made by adding a subdivision (g) to Section 16336:

(g) Nothing in this section or in this chapter is intended to create or imply a duty to make an adjustment under this section. A trustee is not liable for refusing or choosing not to make an adjustment.

The first paragraph of the Comment would be expanded with the following:

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 accrue under a duty, such as the duty to comply with the prudent investor rule (Section 16046) or the duty to treat beneficiaries impartially (Section 16003).

3. Consequence of Objection to Proposed Action

Section 16337, the notice of proposed action provision, should be revised to make subdivision (g) consistent with subdivision (f) in a case where the trustee does not take the proposed action due to an objection:

(f) A trustee is not liable to a beneficiary for an action regarding a matter governed by this chapter if the trustee does not receive a written objection to the proposed action from the beneficiary within the applicable period and the other requirements of this section are satisfied. If no beneficiary entitled to notice objects under this section, the trustee is not liable to any current or future beneficiary with respect to the proposed action.

(g) If the trustee receives a written objection within the applicable period, either the trustee or a beneficiary may petition the court to have the proposed action taken as proposed, taken with

modifications, or denied. In the proceeding, a beneficiary objecting to the proposed action has the burden of proving that the trustee's proposed action should not be taken. A beneficiary who has not objected is not estopped from opposing the proposed action in the proceeding. If the trustee decides not to implement the proposed action, the trustee shall notify the beneficiaries of the decision not to take the action and the reasons for the decision, and is not liable to any current or future beneficiary with respect to the unimplemented action. A beneficiary may petition the court to have the action taken, and has the burden of proving that it should be taken.

4. Remedy for Improper or Incorrect Adjustment

A new section should be added to make clear that in a dispute over exercise of the adjustment power, the remedy is to revise or reverse the adjustment and not to surcharge the trustee. This would be implemented by adding a new Section 16338 (and renumber the other section of that number as Section 16339):

§ 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 proper level of an adjustment.

Conclusion

There may be some additional technical amendments and some revisions may be needed in the language proposed above, but the staff believes that the interested parties have come to a basic agreement that resolves all substantive issues in the bill. The eight participants in the conference on March 19th left in an atmosphere of cooperation and consensus that should smooth the course of AB 846 in the Legislature. We understand that there are one or two higher policy-determining levels within CBA, but we are optimistic that the agreement

hammered out with the trust experts on the CBA Trust State Government Relations Committee will be approved.

Respectfully submitted,

Stan Ulrich
Assistant Executive Secretary

Exhibit

PROPOSED REVISIONS TO AB 846 (UPAIA)

☞ **Staff Note.** This Exhibit includes the full text of Article 2 (Prob. Code §§ 16335-16339) from AB 846, which implements the Commission's recommendation on the *Uniform Principal and Income Act*, 29 Cal. L. Revision Comm'n Reports 245 (1999), and includes revisions discussed in Memorandum 99-25 (shown in underscore and strikeout).

Article 2. General Provisions and Fiduciary Duties

§ 16335. General fiduciary duties [UPAIA § 103]

16335. (a) In allocating receipts and disbursements to or between principal and income, and with respect to any other matter within the scope of this chapter, a fiduciary:

(1) Shall administer a trust or decedent's estate in accordance with the trust or the will, even if there is a different provision in this chapter.

(2) May administer a trust or decedent's estate by the exercise of a discretionary power of administration given to the fiduciary by the trust or the will, even if the exercise of the power produces a result different from a result required or permitted by this chapter, and no inference that the fiduciary has improperly exercised the discretion arises from the fact that the fiduciary has made an allocation contrary to a provision of this chapter.

(3) Shall administer a trust or decedent's estate in accordance with this chapter if the trust or the will does not contain a different provision or does not give the fiduciary a discretionary power of administration.

(4) Shall add a receipt or charge a disbursement to principal to the extent that the trust or the will and this chapter do not provide a rule for allocating the receipt or disbursement to or between principal and income.

(b) In exercising a discretionary power of administration regarding a matter within the scope of this chapter, whether granted by a trust, a will, or this chapter, including the trustee's power to adjust under subdivision (a) of Section 16336, the fiduciary shall administer the trust or decedent's estate impartially, except to the extent that the trust or the will expresses an intention that the fiduciary shall or may favor one or more of the beneficiaries. The exercise of discretion in accordance with this chapter is presumed to be fair and reasonable to all beneficiaries.

Comment. Section 16335 supersedes former Section 16302 and is generally the same as Section 103 of the Uniform Principal and Income Act (1997), with a number of changes. The last clause in subdivision (a)(2) has been added to preserve and generalize the “no inference” rule in former Section 16302(b). “Trust” is used in place of “terms of the trust” throughout. As provided in the introductory clause of subdivision (a), its rules apply to allocation between principal and income (Sections 16350-16375), as under former Section 16302, but in addition, these rules apply to matters within the scope of Sections 16335-16341.

The rule in the first sentence of subdivision (b) is a special expression of the general fiduciary duty in Section 16003. The wording in the second sentence has been revised to make clear that the presumption applies to exercise of discretion under this chapter.

See also Sections 82 (“trust” defined), 16323 (“fiduciary” defined), 16324 (“income” defined).

Background from Uniform Act

Prior Act. The rule in Section 2(a) of the 1962 Act [former Prob. Code § 16302] is restated in Section 103(a) [Prob. Code § 16335(a)], without changing its substance, to emphasize that the Act contains only default rules and that provisions in the terms of the trust are paramount. However, Section 2(a) of the 1962 Act [former Prob. Code § 16302] applies only to the allocation of receipts and disbursements to or between principal and income. In this Act, the first sentence of Section 103(a) [Prob. Code § 16335(a)] states that it also applies to matters within the scope of Articles [3 (commencing with Probate Code Section 16340)] and [4 (commencing with Probate Code Section 16345)]. Section 103(a)(2) [Prob. Code § 16335(a)(2)] incorporates the rule in Section 2(b) of the 1962 Act [former Prob. Code § 16302(b)] that a discretionary allocation made by the trustee that is contrary to a rule in the Act should not give rise to an inference of imprudence or partiality by the trustee.

....
Fiduciary discretion. The general rule is that if a discretionary power is conferred upon a trustee, the exercise of that power is not subject to control by a court except to prevent an abuse of discretion. Restatement (Second) of Trusts § 187. The situations in which a court will control the exercise of a trustee’s discretion are discussed in the comments to § 187. See also *id.* § 233 comment *p*.

Questions for which there is no provision. Section 103(a)(4) [Prob. Code § 16335(a)(4)] allocates receipts and disbursements to principal when there is no provision for a different allocation in the terms of the trust, the will, or the Act. This may occur because money is received from a financial instrument not available at the present time (inflation-indexed bonds might have fallen into this category had they been announced after this Act was approved by the Commissioners on Uniform State Laws) or because a transaction is of a type or occurs in a manner not anticipated by the Drafting Committee for this Act or the drafter of the trust instrument.

Allocating to principal a disbursement for which there is no provision in the Act or the terms of the trust preserves the income beneficiary’s level of income in the year it is allocated to principal, but thereafter will reduce the amount of income produced by the principal. Allocating to principal a receipt for which there is no provision will increase the income received by the income beneficiary in subsequent years, and will eventually, upon termination of the trust, also favor the remainder beneficiary. Allocating these items to principal implements the rule that requires a trustee to administer the trust impartially, based on what is fair and reasonable to both income and remainder beneficiaries. However, if the trustee decides that an adjustment between principal and income is needed to enable the trustee to comply with Section 103(b) [Prob. Code § 16335(b)], after considering the return from the portfolio as a whole, the trustee may make an appropriate adjustment under Section 104(a) [Prob. Code § 16336(a)].

Duty of impartiality. Whenever there are two or more beneficiaries, a trustee is under a duty to deal impartially with them. Restatement of Trusts 3d: Prudent Investor Rule § 183 (1992). [See Prob. Code § 16003.] This rule applies whether the beneficiaries’ interests in the trust are concurrent or successive. If the terms of the trust give the trustee discretion to favor one beneficiary over another, a court will not control the exercise of such discretion except to prevent

the trustee from abusing it. *Id.* § 183, comment *a*. “The precise meaning of the trustee’s duty of impartiality and the balancing of competing interests and objectives inevitably are matters of judgment and interpretation. Thus, the duty and balancing are affected by the purposes, terms, distribution requirements, and other circumstances of the trust, not only at the outset but as they may change from time to time.” *Id.* § 232, comment *c*.

The terms of a trust may provide that the trustee, or an accountant engaged by the trustee, or a committee of persons who may be family members or business associates, shall have the power to determine what is income and what is principal. If the terms of a trust provide that this Act specifically or principal and income legislation in general does not apply to the trust but fail to provide a rule to deal with a matter provided for in this Act, the trustee has an implied grant of discretion to decide the question. Section 103(b) [Prob. Code § 16335(b)] provides that the rule of impartiality applies in the exercise of such a discretionary power to the extent that the terms of the trust do not provide that one or more of the beneficiaries are to be favored. The fact that a person is named an income beneficiary or a remainder beneficiary is not by itself an indication of partiality for that beneficiary.

[Adapted from Unif. Principal and Income Act § 103 comment (1997).]

§ 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 under this section. A trustee is not liable for refusing or choosing not to make an adjustment.

Comment. Section 16336 is the same as parts of 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 accrue under a duty, such as the duty to comply with the prudent investor rule (Section 16046) or the duty to treat beneficiaries impartially (Section 16003).

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).

Background from Uniform Act

Purpose and Scope of Provision. The purpose of Section 104 [Prob. Code § 16336] is to enable a trustee to select investments using the standards of a prudent investor without having to realize a particular portion of the portfolio's total return in the form of traditional trust accounting income such as interest, dividends, and rents. Section 104(a) [Prob. Code § 16336(a)] authorizes a trustee to make adjustments between principal and income if three conditions are met: (1) the trustee must be managing the trust assets under the prudent investor rule; (2) the terms of the trust must express the income beneficiary's distribution rights in terms of the right to receive "income" in the sense of traditional trust accounting income; and (3) the trustee must determine, after applying the rules in Section 103(a) [Prob. Code § 16335(a)], that he is unable to comply with Section 103(b) [Prob. Code § 16335(b)].... [The] trustee may not make an adjustment in circumstances described in Section 104(c) [Prob. Code § 16336(b)].

Section 104 [Prob. Code § 16336] does not empower a trustee to increase or decrease the degree of beneficial enjoyment to which a beneficiary is entitled under the terms of the trust; rather, it authorizes the trustee to make adjustments between principal and income that may be necessary if the income component of a portfolio's total return is too small or too large because of investment decisions made by the trustee under the prudent investor rule. The paramount consideration in applying Section 104(a) [Prob. Code § 16336(a)] is the requirement in Section 103(b) [Prob. Code § 16335(b)] that "a fiduciary must administer a trust or estate impartially ..., except to the extent that the terms of the trust or the will clearly manifest an intention that the fiduciary shall or may favor one or more of the beneficiaries." The power to adjust is subject to control by the court to prevent an abuse of discretion. Restatement (Second) of Trusts § 187 (1959). See also *id.* §§ 183, 232, 233, Comment *p* (1959).

Section 104 [Prob. Code § 16336] will be important for trusts that are irrevocable when a State adopts the prudent investor rule by statute or judicial approval of the rule in Restatement of Trusts 3d: Prudent Investor Rule. Wills and trust instruments executed after the rule is adopted can be

drafted to describe a beneficiary's distribution rights in terms that do not depend upon the amount of trust accounting income, but to the extent that drafters of trust documents continue to describe an income beneficiary's distribution rights by referring to trust accounting income, Section 104 [Prob. Code § 16336] will be an important tool in trust administration.

Three conditions to the exercise of the power to adjust. The first of the three conditions [Prob. Code § 16336(a)(1)] that must be met before a trustee can exercise the power to adjust — that the trustee invest and manage trust assets as a prudent investor — is expressed in this Act by language derived from the Uniform Prudent Investor Act, but the condition will be met whether the prudent investor rule applies because the Uniform Act or other prudent investor legislation has been enacted, the prudent investor rule has been approved by the courts, or the terms of the trust require it. Even if a State's legislature or courts have not formally adopted the rule, the Restatement establishes the prudent investor rule as an authoritative interpretation of the common law prudent man rule, referring to the prudent investor rule as a "modest reformulation of the Harvard College dictum and the basic rule of prior Restatements." Restatement of Trusts 3d: Prudent Investor Rule, Introduction, at 5. As a result, there is a basis for concluding that the first condition is satisfied in virtually all States except those in which a trustee is permitted to invest only in assets set forth in a statutory "legal list."

The second condition [Prob. Code § 16336(a)(2)] will be met when the terms of the trust require all of the "income" to be distributed at regular intervals; or when the terms of the trust require a trustee to distribute all of the income, but permit the trustee to decide how much to distribute to each member of a class of beneficiaries; or when the terms of a trust provide that the beneficiary shall receive the greater of the trust accounting income and a fixed dollar amount (an annuity), or of trust accounting income and a fractional share of the value of the trust assets (a unitrust amount). If the trust authorizes the trustee in its discretion to distribute the trust's income to the beneficiary or to accumulate some or all of the income, the condition will be met because the terms of the trust do not permit the trustee to distribute more than the trust accounting income.

To meet the third condition [Prob. Code § 16336(a)(3)], the trustee must first meet the requirements of Section 103(a) [Prob. Code § 16335(a)], i.e., she must apply the terms of the trust, decide whether to exercise the discretionary powers given to the trustee under the terms of the trust, and must apply the provisions of the Act if the terms of the trust do not contain a different provision or give the trustee discretion. Second, the trustee must determine the extent to which the terms of the trust clearly manifest an intention by the settlor that the trustee may or must favor one or more of the beneficiaries. To the extent that the terms of the trust do not require partiality, the trustee must conclude that she is unable to comply with the duty to administer the trust impartially. To the extent that the terms of the trust do require or permit the trustee to favor the income beneficiary or the remainder beneficiary, the trustee must conclude that she is unable to achieve the degree of partiality required or permitted. If the trustee comes to either conclusion — that she is unable to administer the trust impartially or that she is unable to achieve the degree of partiality required or permitted — she may exercise the power to adjust under Section 104(a) [Prob. Code § 16336(a)].

Impartiality and productivity of income. The duty of impartiality between income and remainder beneficiaries is linked to the trustee's duty to make the portfolio productive of trust accounting income whenever the distribution requirements are expressed in terms of distributing the trust's "income." The 1962 Act implies that the duty to produce income applies on an asset by asset basis because the right of an income beneficiary to receive "delayed income" from the sale proceeds of underproductive property under Section 12 of that Act arises if "any part of principal ... has not produced an average net income of a least 1% per year of its inventory value for more than a year" Under the prudent investor rule, "[t]o whatever extent a requirement of income productivity exists, ... the requirement applies not investment by investment but to the portfolio as a whole." Restatement of Trusts 3d: Prudent Investor Rule § 227, Comment *i*, at 34. [See Prob. Code § 16047.] The power to adjust under Section 104(a) [Prob. Code § 16336(a)] is also to be exercised by considering net income from the portfolio as a whole and not investment by investment. Section 413(b) of this Act [Prob. Code § 16365(b)] eliminates the underproductive property rule in all cases other than trusts for which a marital deduction is allowed; the rule

applies to a marital deduction trust if the trust's assets "consist substantially of property that does not provide the spouse with sufficient income from or use of the trust assets ..." — in other words, the section applies by reference to the portfolio as a whole.

While the purpose of the power to adjust in Section 104(a) [Prob. Code § 16336(a)] is to eliminate the need for a trustee who operates under the prudent investor rule to be concerned about the income component of the portfolio's total return, the trustee must still determine the extent to which a distribution must be made to an income beneficiary and the adequacy of the portfolio's liquidity as a whole to make that distribution.

For a discussion of investment considerations involving specific investments and techniques under the prudent investor rule, see Restatement of Trusts 3d: Prudent Investor Rule § 227, Comments *k-p*. [See also Prob. Code §§ 16045-16052, California Uniform Prudent Investor Act.]

Factors to consider in exercising the power to adjust. Section 104(b) requires [not required in Prob. Code § 16336 — factors are listed in the California Comment, *supra*, as factors that are "appropriate to consider"] a trustee to consider factors relevant to the trust and its beneficiaries in deciding whether and to what extent the power to adjust should be exercised. Section 2(c) of the Uniform Prudent Investor Act [see Prob. Code § 16047(c)] sets forth circumstances that a trustee is to consider in investing and managing trust assets. The circumstances in Section 2(c) of the Uniform Prudent Investor Act are the source of the factors in paragraphs (3) through (6) and (8) of Section 104(b) (modified where necessary to adapt them to the purposes of this Act) so that, to the extent possible, comparable factors will apply to investment decisions and decisions involving the power to adjust. If a trustee who is operating under the prudent investor rule decides that the portfolio should be composed of financial assets whose total return will result primarily from capital appreciation rather than dividends, interest, and rents, the trustee can decide at the same time the extent to which an adjustment from principal to income may be necessary under Section 104. On the other hand, if a trustee decides that the risk and return objectives for the trust are best achieved by a portfolio whose total return includes interest and dividend income that is sufficient to provide the income beneficiary with the beneficial interest to which the beneficiary is entitled under the terms of the trust, the trustee can decide that it is unnecessary to exercise the power to adjust.

Assets received from the settlor. Section 3 of the Uniform Prudent Investor Act provides that "[a] trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying." [For a comparable rule, see Prob. Code § 16048.] The special circumstances may include the wish to retain a family business, the benefit derived from deferring liquidation of the asset in order to defer payment of income taxes, or the anticipated capital appreciation from retaining an asset such as undeveloped real estate for a long period. To the extent the trustee retains assets received from the settlor because of special circumstances that overcome the duty to diversify, the trustee may take these circumstances into account in determining whether and to what extent the power to adjust should be exercised to change the results produced by other provisions of this Act that apply to the retained assets. See Section 104(b)(5) [omitted in California]; Uniform Prudent Investor Act § 3, Comment, 7B U.L.A. 18, at 25-26 (Supp. 1997); Restatement of Trusts 3d: Prudent Investor Rule § 229 and Comments *a-e*.

Limitations on the power to adjust. The purpose of subsections (c)(1) through (4) [Prob. Code § 16336(b)(1)-(4)] is to preserve tax benefits that may have been an important purpose for creating the trust. Subsections (c)(5), (6), and (8) [Prob. Code § 16336(b)(5)-(6); UPAIA subsection (c)(8) is omitted in California] deny the power to adjust in the circumstances described in those subsections in order to prevent adverse tax consequences, and subsection (c)(7) [Prob. Code § 16336(b)(7)] denies the power to adjust to any beneficiary, whether or not possession of the power may have adverse tax consequences.

Under subsection (c)(1) [Prob. Code § 16336(b)(1)], a trustee cannot make an adjustment 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 is allowed; but this subsection does not prevent the trustee from making an adjustment that increases the amount of income paid from a marital deduction trust to the spouse. Subsection (c)(1) [Prob. Code § 16336(b)(1)] applies

to a trust that qualifies for the marital deduction because the spouse has a general power of appointment over the trust, but it applies to a qualified terminable interest property (QTIP) trust only if and to the extent that the fiduciary makes the election required to obtain the tax deduction. Subsection (c)(1) [Prob. Code § 16336(b)(1)] does not apply to a so-called “estate” trust. This type of trust qualifies for the marital deduction because the terms of the trust require the principal and undistributed income to be paid to the surviving spouse’s estate when the spouse dies; it is not necessary for the terms of an estate trust to require the income to be distributed annually. Reg. § 20.2056(c)-2(b)(1)(iii).

Subsection (c)(3) [Prob. Code § 16336(b)(3)] applies to annuity trusts and unitrusts with no charitable beneficiaries as well as to trusts with charitable income or remainder beneficiaries; its purpose is to make it clear that a beneficiary’s right to receive a fixed annuity or a fixed fraction of the value of a trust’s assets is not subject to adjustment under Section 104(a) [Prob. Code § 16336(a)]. Subsection (c)(3) [Prob. Code § 16336(b)(3)] does not apply to any additional amount to which the beneficiary may be entitled that is expressed in terms of a right to receive income from the trust. For example, if a beneficiary is to receive a fixed annuity or the trust’s income, whichever is greater, subsection (c)(3) [Prob. Code § 16336(b)(3)] does not prevent a trustee from making an adjustment under Section 104(a) [Prob. Code § 16336(a)] in determining the amount of the trust’s income.

If subsection (c)(5), (6), (7), or (8) [Prob. Code § 16336(b)(5)-(6); UPAIA subsection (c)(8) is omitted in California], prevents a trustee from exercising the power to adjust, subsection (d) [Prob. Code § 16336(c)] permits a cotrustee who is not subject to the provision to exercise the power unless the terms of the trust do not permit the cotrustee to do so.

Release of the power to adjust. Section 104(e) [Prob. Code § 16336(d)-(e)] permits a trustee to release all or part of the power to adjust in circumstances in which the possession or exercise of the power might deprive the trust of a tax benefit or impose a tax burden. For example, if possessing the power would diminish the actuarial value of the income interest in a trust for which the income beneficiary’s estate may be eligible to claim a credit for property previously taxed if the beneficiary dies within ten years after the death of the person creating the trust, the trustee is permitted under subsection (e) [Prob. Code § 16336(d)] to release just the power to adjust from income to principal.

Trust terms that limit a power to adjust. Section 104(f) [Prob. Code § 16336(f)] applies to trust provisions that limit a trustee’s power to adjust. Since the power is intended to enable trustees to employ the prudent investor rule without being constrained by traditional principal and income rules, an instrument executed before the adoption of this Act whose terms describe the amount that may or must be distributed to a beneficiary by referring to the trust’s income or that prohibit the invasion of principal or that prohibit equitable adjustments in general should not be construed as forbidding the use of the power to adjust under Section 104(a) [Prob. Code § 16336(a)] if the need for adjustment arises because the trustee is operating under the prudent investor rule. Instruments containing such provisions that are executed after the adoption of this Act should specifically refer to the power to adjust if the settlor intends to forbid its use. See generally, Joel C. Dobris, *Limits on the Doctrine of Equitable Adjustment in Sophisticated Postmortem Tax Planning*, 66 Iowa L. Rev. 273 (1981).

Examples. The following examples illustrate the application of Section 104 [Prob. Code § 16336]:

Example (1) — *T* is the successor trustee of a trust that provides income to *A* for life, remainder to *B*. *T* has received from the prior trustee a portfolio of financial assets invested 20% in stocks and 80% in bonds. Following the prudent investor rule, *T* determines that a strategy of investing the portfolio 50% in stocks and 50% in bonds has risk and return objectives that are reasonably suited to the trust, but *T* also determines that adopting this approach will cause the trust to receive a smaller amount of dividend and interest income. After considering the [relevant] factors ..., *T* may transfer cash from principal to income to the extent *T* considers it necessary to increase the amount distributed to the income beneficiary.

Example (2) — *T* is the trustee of a trust that requires the income to be paid to the settlor’s son *C* for life, remainder to *C*’s daughter *D*. In a period of very high inflation, *T* purchases bonds that

pay double-digit interest and determines that a portion of the interest, which is allocated to income under Section 406 of this Act [Prob. Code § 16357], is a return of capital. In consideration of the loss of value of principal due to inflation and other factors that *T* considers relevant, *T* may transfer part of the interest to principal.

Example (3) — *T* is the trustee of a trust that requires the income to be paid to the settlor's sister *E* for life, remainder to charity *F*. *E* is a retired schoolteacher who is single and has no children. *E*'s income from her social security, pension, and savings exceeds the amount required to provide for her accustomed standard of living. The terms of the trust permit *T* to invade principal to provide for *E*'s health and to support her in her accustomed manner of living, but do not otherwise indicate that *T* should favor *E* or *F*. Applying the prudent investor rule, *T* determines that the trust assets should be invested entirely in growth stocks that produce very little dividend income. Even though it is not necessary to invade principal to maintain *E*'s accustomed standard of living, she is entitled to receive from the trust the degree of beneficial enjoyment normally accorded a person who is the sole income beneficiary of a trust, and *T* may transfer cash from principal to income to provide her with that degree of enjoyment.

Example (4) — *T* is the trustee of a trust that is governed by the law of State X. The trust became irrevocable before State X adopted the prudent investor rule. The terms of the trust require all of the income to be paid to *G* for life, remainder to *H*, and also give *T* the power to invade principal for the benefit of *G* for "dire emergencies only." The terms of the trust limit the aggregate amount that *T* can distribute to *G* from principal during *G*'s life to 6% of the trust's value at its inception. The trust's portfolio is invested initially 50% in stocks and 50% in bonds, but after State X adopts the prudent investor rule *T* determines that, to achieve suitable risk and return objectives for the trust, the assets should be invested 90% in stocks and 10% in bonds. This change increases the total return from the portfolio and decreases the dividend and interest income. Thereafter, even though *G* does not experience a dire emergency, *T* may exercise the power to adjust under Section 104(a) [Prob. Code § 16336(a)] to the extent that *T* determines that the adjustment is from only the capital appreciation resulting from the change in the portfolio's asset allocation. If *T* is unable to determine the extent to which capital appreciation resulted from the change in asset allocation or is unable to maintain adequate records to determine the extent to which principal distributions to *G* for dire emergencies do not exceed the 6% limitation, *T* may not exercise the power to adjust. See Joel C. Dobris, *Limits on the Doctrine of Equitable Adjustment in Sophisticated Postmortem Tax Planning*, 66 Iowa L. Rev. 273 (1981).

Example (5) — *T* is the trustee of a trust for the settlor's child. The trust owns a diversified portfolio of marketable financial assets with a value of \$600,000, and is also the sole beneficiary of the settlor's IRA, which holds a diversified portfolio of marketable financial assets with a value of \$900,000. The trust receives a distribution from the IRA that is the minimum amount required to be distributed under the Internal Revenue Code, and *T* allocates 10% of the distribution to income under Section 409(c) of this Act [Prob. Code § 16361(c)]. The total return on the IRA's assets exceeds the amount distributed to the trust, and the value of the IRA at the end of the year is more than its value at the beginning of the year. Relevant factors that *T* may consider in determining whether to exercise the power to adjust and the extent to which an adjustment should be made to comply with Section 103(b) [Prob. Code § 16335(b)] include the total return from all of the trust's assets, those owned directly as well as its interest in the IRA, the extent to which the trust will be subject to income tax on the portion of the IRA distribution that is allocated to principal, and the extent to which the income beneficiary will be subject to income tax on the amount that *T* distributes to the income beneficiary.

Example (6) — *T* is the trustee of a trust whose portfolio includes a large parcel of undeveloped real estate. *T* pays real property taxes on the undeveloped parcel from income each year pursuant to Section 501(3) [Prob. Code § 16370(c)]. After considering the return from the trust's portfolio as a whole and other relevant factors ..., *T* may exercise the power to adjust under Section 104(a) [Prob. Code § 16336(a)] to transfer cash from principal to income in order to distribute to the income beneficiary an amount that *T* considers necessary to comply with Section 103(b) [Prob. Code § 16335(b)].

Example (7) — *T* is the trustee of a trust whose portfolio includes an interest in a mutual fund that is sponsored by *T*. As the manager of the mutual fund, *T* charges the fund a management fee that reduces the amount available to distribute to the trust by \$2,000. If the fee had been paid directly by the trust, one-half of the fee would have been paid from income under Section 501(1) [Prob. Code § 16370(a)] and the other one-half would have been paid from principal under Section 502(a)(1) [Prob. Code § 16371(a)(1)]. After considering the total return from the portfolio as a whole and other relevant factors . . . , *T* may exercise its power to adjust under Section 104(a) [Prob. Code § 16336(a)] by transferring \$1,000, or half of the trust's proportionate share of the fee, from principal to income.

[Adapted from Unif. Principal and Income Act § 104 comment (1997).]

§ 16337. Notice of proposed action

16337. (a) A trustee may give a notice of proposed action regarding a matter governed by this chapter as provided in this section. For the purpose of this section, a proposed action includes a course of action and a decision not to take action.

(b) The trustee shall mail notice of the proposed action to all adult beneficiaries who are receiving or are entitled to receive income under the trust or to receive a distribution of principal if the trust were terminated at the time the notice is given.

(c) Notice of proposed action need not be given to any person who consents in writing to the proposed action. The consent may be executed at any time before or after the proposed action is taken.

(d) The notice of proposed action shall state that it is given pursuant to this section and shall state all of the following:

(1) The name and mailing address of the trustee.

(2) The name and telephone number of a person who may be contacted for additional information.

(3) A description of the action proposed to be taken and an explanation of the reasons for the action.

(4) The time within which objections to the proposed action can be made, which shall be at least 30 days from the mailing of the notice of proposed action.

(5) The date on or after which the proposed action may be taken or is effective.

(e) A beneficiary may object to the proposed action by mailing a written objection to the trustee at the address stated in the notice of proposed action within the time period specified in the notice of proposed action.

(f) A trustee is not liable to a beneficiary for an action regarding a matter governed by this chapter if the trustee does not receive a written objection to the proposed action from the beneficiary within the applicable period and the other requirements of this section are satisfied. If no beneficiary entitled to notice objects under this section, the trustee is not liable to any current or future beneficiary with respect to the proposed action.

(g) If the trustee receives a written objection within the applicable period, either the trustee or a beneficiary may petition the court to have the proposed action taken as proposed, taken with modifications, or denied. In the proceeding, a beneficiary objecting to the proposed action has the burden of proving that the

trustee's proposed action should not be taken. A beneficiary who has not objected is not estopped from opposing the proposed action in the proceeding. If the trustee decides not to implement the proposed action, the trustee shall notify the beneficiaries of the decision not to take the action and the reasons for the decision, and is not liable to any current or future beneficiary with respect to the unimplemented action. A beneficiary may petition the court to have the action taken, and has the burden of proving that it should be taken.

Comment. Section 16337 is new. This section provides a special notice of proposed action procedure applicable to principal and income allocation matters governed by this chapter. This procedure does not apply generally to trust administration. Some features of this procedure are drawn from the notice of proposed action procedure (see, e.g., Sections 10582, 10585-10587) under the Independent Administration of Estates Act (Section 10400 *et seq.*). This section applies only to notice of proposed action given by trustees. Personal representatives with authority under the Independent Administration of Estates Act have the option of using the notice of proposed action procedure under that act. See Sections 10531(a) (principal and income allocations and determinations), 10580(b) (optional use of notice of proposed action procedure).

See also Section 1215 (manner of giving notice). For judicial proceedings concerning trusts, see, e.g., Section 17200.

§ 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 proper level of an adjustment.

§ ~~16338~~ 16339. Application of chapter to existing trusts and estates [UPAIA § 605]

~~16338~~ 16339. This chapter applies to every trust or decedent's estate existing on January 1, 2000, except as otherwise expressly provided in the trust or will or in this chapter.

Comment. Section ~~16338~~ 16339 is the same in substance as Section 605 of the Uniform Principal and Income Act (1997).

See also Section 3 (general transitional provisions).