

Memorandum 84-32

Subject: Study L-640 - Trusts (Revised Uniform Principal and Income Act)

In California the problem of allocating trust receipts and expenditures between income beneficiaries and remaindermen is governed by the Revised Uniform Principal and Income Act (1962) [hereinafter referred to as RUPIA]. The RUPIA has been enacted in about half of the states, subject to more or less significant variations. The California version, as renumbered to fit in the tentative trust law outline, is attached to this memorandum as Exhibit 1.

Several states have recently analyzed the RUPIA, notably Nebraska, Texas, and Wisconsin. This memorandum considers substantive revisions enacted in these and other states in relation to the California version. This memorandum proceeds from the assumption that the California RUPIA is adequate and can be continued with only a few revisions. However, the statute could benefit from editorial changes such as those made in the Texas Trust Code. The California RUPIA is discussed section by section in the material below.

Location of RUPIA

Under existing law, the RUPIA is set out as Sections 730-730.17 of the Civil Code. It should be moved to the Probate Code since it deals with the duty of a trustee to administer a trust with due regard for the respective interests of income beneficiaries and remaindermen.

The RUPIA is followed in the Civil Code by the Legal Estates Principal and Income Law. Civil Code §§ 731-731.15 (enacted in 1968). It appears that this law was enacted to fill the gap left when California replaced its broad principal and income law in 1967 with the RUPIA which is limited to trust estates. See 3 B. Witkin, Summary of California Law Real Property § 286, at 1999 (8th ed. 1973). The Legal Estates Principal and Income Act is based on the 1931 Uniform Principal and Income Act. At this point, the staff does not suggest any changes in the law relating to legal estates, but if the Commission decides to make any significant changes in the RUPIA, we will analyze the legal estates provisions to see whether any conforming changes are needed.

Draft § 4801. Effect on tax laws

The staff has discovered almost no legislative history for the California RUPIA, and as a consequence we are unable to discover the

purpose of this section providing that the RUPIA has no effect on the personal and corporate income tax laws. It is not a uniform act provision and we would like to eliminate it if we could be confident that it serves no special purpose. It is difficult to imagine what effect the constructional provisions of the RUPIA would have on the income tax statutes. It might also be asked what other laws the RUPIA should not affect if there is truly a danger of its influence spreading beyond the confines of trust law.

Draft § 4802. Definitions

There is a lot of variation in enacting states in this section providing certain definitions. In the draft statute, we have continued existing law. However, the definition in subdivision (d) of "trustee" is not necessary in light of the definition in new Probate Code Section 84 and so it should be deleted. The new Texas Trust Code contains only the definitions of "inventory value" and "trustee" and locates them in a section providing definitions for the entire code. See Tex. Trust Code § 111.004.

Wisconsin omits all references to "income beneficiary" and "remainderman" in its RUPIA. This approach has also found favor in the recent Nebraska revision. See Volkmer, Nebraska's Trustees' Powers Act and Principal and Income Act: The New Look in Nebraska Trust Law, 14 Creighton L. Rev. 121, 137 (1980). This omission results in a slightly broader coverage of the Wisconsin and Nebraska acts, since they also apply where there is only one beneficiary who is to receive the trust property at a later date. It is claimed that the RUPIA would be valuable in this situation for accounting and tax purposes, even though there is not the usual case of competing interests of income beneficiaries and remaindermen. Id., at 137 n.93. The staff is not convinced that the Wisconsin-Nebraska approach is necessary.

Draft § 4803. Duty of trustee as to receipts and expenditures

The first sentence of this section states the general rule that the trustee shall administer the trust with due regard for the respective interests of income beneficiaries and remaindermen. This statement does not give trustees much guidance; hence, the remainder of the RUPIA seeks to provide sufficient detail to give the trustee the necessary guidance in the situation where the trust does not provide a contrary rule. As the remainder of this section makes clear, the RUPIA is technically a

rule of construction since it may be overridden by provisions in the trust.

An inconsistency appears in draft Section 4803(a)(3) (which is the same as existing language in Civil Code Section 730.02). This provision applies a prudent person standard based on the actions in management of one's own affairs. This is the same as part of the standard generally applicable through Civil Code Section 2261(1), but does not contain the qualifying language of the general section. If Section 2261 is amended, as currently proposed in AB 630 (see Memorandum 84-21), there will be a greater inconsistency between these provisions. The staff proposes to delete this reference to the prudent person standard. (The comment to the section would provide a cross-reference to the general standard.) This is the approach taken by some other states, notably Texas, Wisconsin, Nebraska, and North Dakota. The assumption supporting this suggestion is that the general standard governing trustee conduct would apply to this duty as it does to any other. The danger of restating the prudent person standard in the RUPIA is that the formulation of the standard will become discordant with the general standard.

In subdivision (b) of this section there is a provision that "no inference of imprudence or impartiality" arises from a contrary allocation in a situation where the trustee has discretion. Both Nebraska and Texas have phrased this provision more broadly. In Nebraska no inference arises "that the trustee has improperly exercised such discretion from the fact that the trustee has made an allocation contrary" to the Nebraska RUPIA. See Volkmer, supra, at 138. Section 113.101 of the Texas Trust Code provides simply that "no inference arises from the fact that the trustee makes an allocation contrary to" the Texas statute where the trustee has discretion. The staff prefers the Texas draft and finds the Nebraska draft superior to the uniform act language enacted in California.

Professor Volkmer reports that most drafters resort to a discretionary clause, at least in Nebraska. Volkmer, supra, at 139. If this is true generally, it is an interesting phenomenon since the whole idea behind the uniform principal and income acts was to provide guidance where definite rules in this complicated area were lacking or the common law rules were outdated. It would be excessive, however, to make the RUPIA rules mandatory. The allocation rules must remain subject to contrary provision in the trust instrument, and trustors who thought-

lessly grant overly broad discretion to their trustees will have to risk the consequences. As reported by Volkmer, the problems may involve adverse tax consequences in the case of a charitable deduction. Id. In California if a trustee is given discretion that avoids application of the RUPIA, the general standard of reasonable exercise of powers would still apply. See draft Section 4350 attached to Memorandum 84-21.

Draft § 4804. Principal and income

Subdivisions (a) and (b) of this section are definitions of income and principal; subdivision (c) imposes a duty. Subdivision (c) should be split from the definitional provisions as was done in Nebraska.

As far as substance is concerned, several states have tinkered with the various elements of these definitions. Texas omits subdivision (a)(3) relating to income earned during administration of a decedent's estate, consistent with the omission of the uniform act provision referred to in subdivision (a)(3). See Tex. Trust Code § 113.102. Wisconsin and Nebraska omit subdivision (a)(9) since they have omitted the RUPIA provision on underproductive property. See Volkmer, supra, at 140. Maryland, Minnesota, and Oregon also make various changes and omissions, but none of these variations strikes the staff as particularly useful for California.

Wisconsin and Nebraska add to the definition of income "proceeds of insurance from the loss of income." These states add to the definition of principal "income added to and held as principal." Should these provisions be added to the California statute?

Texas omits what is the first sentence of subdivision (b) in draft Section 4804. The staff assumes this was done because the general concept of "principal" is understood. This omission may also be a reaction to the inartful drafting of this definition. The Commission should consider its omission or revision.

Draft § 4805. When right to income arises; apportionment of income

California has made significant variations in this section of the RUPIA. In the case of assets coming into the trust by reason of a will, Section 4(b) of the RUPIA provides that "periodic payments (other than corporate distributions to stockholders), including rent, interest, or annuities, not due at the date of the death of the testator shall be treated as accruing from day to day." [Emphasis added.] The amounts accruing on this basis before death are principal; amounts accruing after death are income. In other cases, such as inter vivos trusts,

Section 4(c) of the RUPIA treats receipts as income even though earned before the asset became subject to the trust. The logic of this scheme is that a trustor under an inter vivos trust is presumed to want all receipts to go to income unless the trust otherwise provides. Since the time of death is not usually predictable, such a presumption does not apply in the case of a testamentary trust.

By way of contrast, California provides, as to assets becoming subject to the trust by reason of a will, that "periodic payments not due at the date of the death of the testator (other than rents, annuities, interest on bank savings accounts, interest on savings and loan association accounts, and corporate distributions to stockholders) shall be treated as accruing from day to day." [Emphasis added.] The reason for this variation in the treatment of rents, interest, and annuities is not clear. The California approach may be intended to avoid a day-to-day allocation in the common case--rents, interest, annuities, and dividends--perhaps in the interest of administrative simplicity. By this variation, California retains the common law rule that rents, interest, annuities, and dividends are not apportioned (see Restatement (Second) of Trusts § 235 (1959)), notwithstanding the RUPIA change which has apparently found wide acceptance. Hence, under the California rule the date a payment falls due determines its disposition. Does the Commission wish to continue this California variation of the RUPIA? As far as the staff has been able to discover, California stands alone in this variation, although any state that has not adopted the RUPIA would come to the same conclusion if the common law governs. Ultimately the policy choice between rules may be a toss-up. It should also be remembered that we are considering rules of construction here, so that if there is a sense that injustice would result, a trustor may provide alternate rules and a trustee with discretion would not be affected by the statutory rules. In the case of monthly payments, the effort of apportioning the various payments probably is not worth the administrative cost and effort involved. One can imagine injustices, however, such as in a case where the periodic payment is an annual payment and the trustor dies on the next to last day of the year; in leap years the day-to-day rule could give one person 365/366ths of the total under the RUPIA rule but none under the California rule.

In its equivalent of this section, Texas also deals with assets becoming subject to a trust because of the termination of another trust, the crucial date being the date of the event causing termination or the date of distribution from the other trust, whichever occurs first. See Tex. Trust Code § 113.104(a). It is not clear to the staff that this provision adds much to the first sentence of the subdivision which refers to the date an asset becomes subject to the trust.

Draft § 4806. Income earned during administration of decedent's estate

Section 5(a) of the RUPIA deals with the question of allocation of charges against a probate estate before distribution to a trust. In California, this subject is governed by Probate Code Sections 660-664 (operative January 1, 1985) (continuing Prob. Code §§ 160-163). Several states, including California, Maryland, Minnesota, Oregon, and Texas, have omitted this part of the RUPIA since the subject is dealt with in the law relating to probate matters. See generally Volkmer, supra, at 143.

California law provides a non-uniform subdivision (c) relating to proration of income where a trust beneficiary's right to income ceases during probate. This is probably a useful clarification.

Draft § 4807. Corporate distributions

California makes no significant variations in this section of the RUPIA dealing with corporate distributions. Florida has deleted the language in subdivision (b)(3) relating to distributions "other than cash." Wisconsin and Nebraska have omitted subdivision (e) which allows the trustee to rely on statements of a distributing corporation. We do not know the reason for these omissions. Wisconsin and Nebraska also added a provision to this section classifying as principal a corporate distribution of securities in the context of a tax free exchange for federal income tax purposes. See Volkmer, supra, at 147. The staff does not know if this is a beneficial provision.

Draft § 4808. Bonds

California has not varied this section of the RUPIA. Texas omits the second sentence of subdivision (a) prohibiting amortization of bond premiums and accumulation for discount. The California acceptance of the RUPIA provision is inconsistent with the non-uniform provision in Civil Code Section 730.14 (draft Section 4815) which provides that a trustee is not prevented by the California RUPIA from setting aside a

reserve for depreciation or amortization, but is not required to do so. One commentator finds that this provision creates problems where bonds are purchased at a premium. See Ellis, Trustees and Administrative Provisions, in California Will Drafting Practice § 14.69, at 709 (Cal. Cont. Ed. Bar 1982). This problem results because the premium is paid out of principal but the premium is not amortized, resulting in arguably unfair treatment of remaindermen. It appears that the "no amortization" rule should be deleted in California. On the other hand, this is a problem easily solved by proper drafting of the trust instrument, assuming that the trustor is aware of the potential inequity. In the interest of administrative simplicity, the RUPIA adopted the "balancing theory" which assumes premiums and discounts balance out over time so that any inequity to the principal account is minimal. See Note, The Revised Uniform Principal and Income Act--Progress, But Not Perfection, 1963 U. Ill. L. F. 473, 485.

Texas leaves off the last sentence of this section which reads: "Whenever unrealized increment is distributed as income but out of principal, the principal shall be reimbursed for the increment when realized." The staff is sympathetic to this omission.

Draft § 4809. Business and farming operations

Except for the oddity enshrined in subdivision (c) of Section 730.08 (draft Section 4809), California law sets forth the RUPIA provision regarding allocation of business and farming receipts. Subdivision (c) is a cautionary provision that seems to avoid any duty on the part of the trustee to make an allowance for depreciation.

At least four states have discovered some problem with the reference in subdivision (a) to "generally accepted accounting principles." Florida omits the words "generally accepted." Nebraska determined that "generally accepted accounting principles" was a term of art that did not necessarily apply to certain types of businesses operated by a fiduciary and refers instead to "recognized methods of accounting for a comparable business." Volkmer, supra, at 149. Arkansas and Washington substitute a "reasonable and equitable" standard. The staff is unaware of any difficulty that the RUPIA language may have caused in California.

A substantive change made in Wisconsin and Nebraska provides for carrying forward losses under subdivision (a). The argument in favor of the Wisconsin-Nebraska approach is illustrated by the following:

Suppose a business operated by a trustee has an operating loss in a given year. This loss falls upon the remainderman. The next year the business produces a profit. Shouldn't the loss be carried forward in order to prevent a windfall for the income beneficiary? Unless the loss is carried forward, the income beneficiary appears to get a free ride at the expense of the remainderman. The remainderman, of course, can argue that he is entitled to the corpus of the trust intact, and that the good year should be unaffected by the bad in order to keep the value of corpus at a relatively stable figure.

Volkmer, supra, at 149 n.164. The staff has not discovered the reason for the RUPIA "no carryover" rule. A New York review of this provision concluded that the "no carry forward" rule is "sensible, since such a loss would not be carried forward if the business happened to be incorporated." Barclay, The Principal and Income Act, 33 Brooklyn L. Rev. 489, 495 (1967).

Draft § 4810. Disposition of natural resources

Many variations have been made in this section of the RUPIA, probably because of the difficulty of allocating receipts from "wasting assets." The approach of the RUPIA, following Texas law, has been to provide for depletion payments. California law follows this approach, but gives the trustee absolute discretion to determine whether to allocate up to 27-1/2% of the gross receipts to principal. Under Section 9 of the RUPIA the depletion allowance in this amount is mandatory (subject to a 50% of net receipts ceiling). The effect of the California approach is not terribly significant, however, since the statutory rule is subject to rules stated in the trust instrument. Under the RUPIA, the trustee would not have discretion in this matter unless the trust instrument provided for it. Under the California statute, the trustee has discretion unless the trust instrument provides some other rule governing allowances for depletion of natural resources. Perhaps the drafters wanted to avoid a mandatory 27-1/2% depletion allowance as being too rigid in a case where the trustor had not provided specific rules. New Mexico also follows the California approach. The staff does not think it is very important whether California is in line with the RUPIA in this respect.

The 27-1/2% figure should be replaced with more general language, however, since the federal tax laws from which the figure was derived has been changed. A reference to the portion of gross receipts allowed as a deduction for depletion in computing taxable income for federal

income tax purposes should be substituted for the 27-1/2% figure. This has been done in Florida, Nebraska, New York, Washington, and Wisconsin. One commentator suggests that to "apply the varying percentages of the Internal Revenue Code applicable to types [of natural resources] other than oil and gas would have created too many complications." Barclay, supra, at 495. The staff is not convinced by this argument.

Draft § 4811. Timber

Under Section 10 of the RUPIA, timber receipts are allocated according to the "reasonable and equitable" standard. California substitutes an absolute discretion standard. Of course, there is no "absolute discretion" for the trustee must still act reasonably (see draft Section 4351 attached to Memorandum 84-21), so there may not be as much difference between California law and the RUPIA as first appears.

Timber, water, soil, sod, dirt, turf, and mosses are omitted from the coverage of natural resources in draft Section 4810. Timber is dealt with in draft Section 4811. The other types of listed resources are governed by draft Section 4812 if they are subject to depletion, or by the general rule of draft Section 4803 if they are not subject to depletion. This somewhat confusing structure is drawn from the RUPIA. Some states have attempted to improve the organization in this area. For example, Florida and Nebraska treat timber and other items excluded from the natural resources provision (draft Section 4810) in one section. Oregon treats timber along with other natural resources and omits this section. In California it would make sense to adopt the Oregon approach since California has enacted variations of both sections to give the trustee discretion to allocate between principal and income, subject to a limit in the amount of a reasonable allowance for depletion, as to timber, or 27-1/2%, in the case of natural resources generally.

Draft § 4812. Other property subject to depletion

In a manner consistent with the two prior sections, California provides that the trustee has absolute discretion to apportion between income and principal so long as the amount allocated to principal does not exceed a reasonable allowance for depletion or amortization. This rule avoids the problems involved in applying the RUPIA standard which allocates to income receipts not in excess of 5% per year of "inventory value" (defined in draft Section 4802). Wisconsin and Nebraska have

also rejected the RUPIA standard, as well as the concept of "inventory value." See Volkmer, supra, at 151. The staff does not suggest changing the California approach, but it is interesting to note that while it may be simpler, it does not give a trustee the sort of guidance that the RUPIA was intended to provide.

Texas has an interesting variation which the Commission may want to consider:

113.109. If part of the principal consists of property other than natural resources or timber that is depletable, such as a leasehold, patent, copyright, royalty, or right to receive payments on a contract for deferred compensation, and the trustee does not have a duty to change the form of the investment, the return from the property is income, but if the trustee has a duty under existing law or the instrument creating the trust to change the form of the investment, as soon as it may be done without sacrifice of value, the return from the property is income up to five percent a year of the inventory value of the property, and the remainder is principal.

Draft § 4813. Underproductive property

This section deals with property that is underproductive such that the interests of the income beneficiary are impaired. This is the reverse of the problem involved with wasting assets. California follows the RUPIA for the most part except that the standard in subdivision (b) is set at 5% rather than 4%, and the RUPIA provision for day-to-day accrual of income is omitted. The staff is unaware of any serious problems with this provision, but the percentage figure seems a bit low under recent economic conditions. Perhaps it should be tied to an indicator or other statute that is revised periodically in response to the economy.

Nebraska and Wisconsin have chosen to omit this provision, in large part because of their rejection of the "inventory value" concept. Volkmer suggests that the more serious problems that arise in this area involve the question of whether a duty to sell unproductive property has arisen and, if so, when. Volkmer, supra, at 154. Texas law has retained its version of the earlier Uniform Principal and Income Act provision on underproductive property. See Tex. Trust Code § 113.110.

Draft § 4814. Charges against income and principal

This section provides rules for determining which expenditures are to be charged against income and which are to be charged against principal. California has altered RUPIA Section 13(a)(2) to provide "absolute

discretion" in the allowance of depreciation. This rule altered the case law in California which, like the RUPIA, required depreciation allowances. See In re Estate of Kelley, 63 Cal.2d 679, 408 P.2d 353, 47 Cal. Rptr. 897 (1965); Comment, Allocation of the Cost of Improvements to Real Property Held in Trust, 19 Hastings L.J. 932, 942-46 (1968). Where the RUPIA chose the simplicity of a mandatory rule, California has chosen a flexible rule designed to permit an equitable allocation, which puts more of an administrative burden on trustees.

The other area of controversy in this section involves the trustee's compensation. The traditional rule was that the trustee's regular compensation was paid out of income while extraordinary expenses were paid out of principal. This rule was adopted by the 1931 Uniform Principal and Income Act, but the RUPIA splits the cost of the trustee's compensation between income and principal. California law reflected the traditional principles until altered by adoption of the RUPIA rule. See In re Estate of Kruce, 10 Cal. App.2d 426, 430, 51 P.2d 1174 (1922). The staff is not aware of any problems with the California version of the RUPIA in this regard.

Another minor variation for which we find no explanation is the omission of a reference to interest in subdivision (c)(5) which in the RUPIA provides that estate and inheritance taxes, "including interest and penalties," are charged to principal. Florida gives the trustee discretion to allocate such interest and penalties.

Draft § 4815. Reserve or allowance for depreciation or depletion

This section is a non-uniform provision which appears to emphasize the California variations relating to the absolute discretion of the trustee with regard to depreciation, depletion, and amortization. It also serves a transitional function. It appears that this section was enacted to deal with the disruption in established practice caused by In re Estate of Kelley, *supra*. See Comment, *supra*, 19 Hastings L.J. at 936. Draft Section 4815 would continue Civil Code Section 730.14, although the need for it would seem to be much diminished from that sensed in 1968.

Draft § 4816. Application of RUPIA

The RUPIA was made applicable to all trusts except to the extent otherwise provided. The rules of the RUPIA should continue to be constructional, and so there is no need to retain this transitional

provision. The staff anticipates that a general section will make the new law apply to all trusts regardless of their date of origin, unless otherwise provided. Hence, draft Section 4816 is unnecessary.

Draft § 4817. Severability

This section is not needed since Section 11 of the Probate Code provides for severability.

Respectfully submitted,

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EXHIBIT 1

Staff Draft of Probate Code §§ 4800-4817

12773

PART 5. REVISED UNIFORM PRINCIPAL AND INCOME ACT

§ 4800. Short title

4800. This part may be cited as the Revised Uniform Principal and Income Act.

Comment. Sections 4800-4817 continue former Civil Code Sections 730-730.17 without substantive change. The source of each section in this part is indicated below.

<u>New Probate Code Section</u>	<u>Former Civil Code Section</u>
4800	730
4801	730a
4802	730.01
4803	730.02
4804	730.03
4805	730.04
4806	730.05
4807	730.06
4808	730.07
4809	730.08
4810	730.09
4811	730.10
4812	730.11
4813	730.12
4814	730.13
4815	730.14, 730.16
4816	730.15, 730.16
4817	730.17

15102

§ 4801. Effect on personal income tax and bank and corporation tax

4801. Nothing in this part affects the provisions of the Personal Income Tax Law and the Bank and Corporation Tax Law.

15643

§ 4802. Definitions

4802. As used in this part:

(a) "Income beneficiary" means the person to whom income is presently payable or for whom it is accumulated for distribution as income.

(b) "Inventory value" means the cost of property purchased by the trustee and the market value of other property at the time it became subject to the trust, but in the case of a testamentary trust the trustee

may use any value finally determined for the purposes of an estate or inheritance tax.

(c) "Remainderman" means the person entitled to principal, including income which has been accumulated and added to principal.

(d) "Trustee" means an original trustee and any successor or added trustee.

15782

§ 4803. Duty of trustee as to receipts and expenditures

4803. (a) A trust shall be administered with due regard to the respective interests of income beneficiaries and remaindermen. A trust is so administered with respect to the allocation of receipts and expenditures if a receipt is credited or an expenditure is charged to income or principal or partly to each in any of the following ways:

(1) In accordance with the terms of the trust instrument, notwithstanding contrary provisions of this part.

(2) In the absence of any contrary terms of the trust instrument, in accordance with the provisions of this part.

(3) If neither paragraph (1) nor (2) is applicable, in accordance with what is reasonable and equitable in view of the interests of those entitled to income as well as of those entitled to principal, and in view of the manner in which persons of ordinary prudence, discretion, and judgment would act in the management of their own affairs.

(b) If the trust instrument gives the trustee discretion in crediting a receipt or charging an expenditure to income or principal or partly to each, no inference of imprudence or partiality arises from the fact that the trustee has made an allocation contrary to a provision of this part.

15783

§ 4804. Income and Principal

4804. (a) Income is the return in money or property derived from the use of principal, including return received as any of the following:

(1) Rent of real or personal property, including sums received for cancellation or renewal of a lease.

(2) Interest on money lent, including sums received as consideration for the privilege of prepayment of principal except as provided in Section 4808 on bond premium and bond discount.

(3) Income earned during administration of a decedent's estate as provided in Section 4806.

(4) Corporate distributions as provided in Section 4807.

(5) Accrued increment on bonds or other obligations issued at discount as provided in Section 4808.

(6) Receipts from business and farming operations as provided in Section 4809.

(7) Receipts from disposition of natural resources as provided in Sections 4810 and 4811.

(8) Receipts from other principal subject to depletion as provided in Section 4812.

(9) Receipts from disposition of underproductive property as provided in Section 4813.

(b) Principal is the property which has been set aside by the owner or the person legally empowered so that it is held in trust eventually to be delivered to a remainderman while the return or use of the principal is in the meantime taken or received by or held for accumulation for an income beneficiary. Principal includes the following:

(1) Consideration received by the trustee on the sale or other transfer of principal or on repayment of a loan or as a refund or replacement or change in the form of principal.

(2) Proceeds of property taken on eminent domain proceedings.

(3) Proceeds of insurance upon property forming part of the principal except proceeds of insurance upon a separate interest of an income beneficiary.

(4) Stock dividends, receipts on liquidation of a corporation, and other corporate distributions as provided in Section 4807.

(5) Receipts from the disposition of corporate securities as provided in Section 4808.

(6) Royalties and other receipts from disposition of natural resources as provided in Sections 4810 and 4811.

(7) Receipts from other principal subject to depletion as provided in Section 4812.

(8) Any profit resulting from any change in the form of principal except as provided in Section 4813 on underproductive property.

(9) Receipts from disposition of underproductive property as provided in Section 4813.

(10) Any allowances for depreciation established under Section 4809 and paragraph (2) of subdivision (a) of Section 4814.

(c) After determining income and principal in accordance with the terms of the trust instrument or of this part, the trustee shall charge to income or principal expenses and other charges as provided in Section 4814.

15785

§ 4805. When right to income arises; apportionment of income

4805. (a) An income beneficiary is entitled to income from the date specified in the trust instrument or, if none is specified, from the date an asset becomes subject to the trust. In the case of an asset becoming subject to a trust by reason of a will, it becomes subject to the trust as of the date of the death of the testator even though there is an intervening period of administration of the testator's estate.

(b) Upon an asset becoming subject to a trust by reason of a will.

(1) Receipts due but not paid at the date of death of the testator are principal.

(2) Receipts in the form of periodic payments not due at the date of the death of the testator (other than rents, annuities, interest on bank savings accounts, interest on savings and loan association accounts, and corporate distributions to stockholders) shall be treated as accruing from day to day. That portion of the receipt accruing before the date of death is principal and the balance is income.

(c) In all other cases, any receipt from an income-producing asset is income even though the receipt was earned or accrued in whole or in part before the date when the asset became subject to the trust.

(d) If an income beneficiary's right to income ceases by death or in any other manner, all payments actually paid to the income beneficiary or in the hands of the trustee for payment to the income beneficiary before such termination belong to the income beneficiary or to his or her personal representative. All income actually received by the trustee after such termination shall be paid to the person next entitled to income by the terms of the trust. This subdivision does not apply to income received by a trustee under subdivision (c) of Section 4806.

(e) Corporate distributions to stockholders shall be treated as due on the day fixed by the corporation for determination of stockholders of

record entitled to distribution or, if no date is fixed, on the date of declaration of the distribution by the corporation.

§ 4806. Income earned during administration of decedent's estate

4806. (a) Unless the will otherwise provides, income from the assets of a decedent's estate after the death of the testator and before distribution, including income from property used to discharge liabilities, shall be distributed in the manner set forth in Chapter 11 (commencing with Section 660) of Division 3.

(b) Income received by a trustee under subdivision (a) shall be treated as income of the trust.

(c) When an income beneficiary's right to income, including interest payable under Section 663, ceases by death or in any other manner during the period of probate administration, income attributable to the period prior to the termination of such right, when subsequently received by the trustee, shall be equitably prorated between the beneficiary or his or her personal representative and the person next entitled to income by the terms of the trust instrument.

§ 4807. Corporate distributions

4807. (a) Corporate distributions of shares of the distributing corporation, including distributions in the form of a stock split or stock dividend, are principal. A right to subscribe to shares or other securities issued by the distributing corporation accruing to stockholders on account of their stock ownership and the proceeds of any sale of the right are principal.

(b) Except to the extent that the corporation indicates that some part of a corporate distribution is a settlement of preferred or guaranteed dividends accrued since the trustee became a stockholder or is in lieu of an ordinary cash dividend, a corporate distribution is principal if the distribution is pursuant to any of the following:

(1) A call of shares.

(2) A merger, consolidation, reorganization, or other plan by which assets of the corporation are acquired by another corporation.

(3) A total or partial liquidation of the corporation, including any distribution which the corporation indicates is a distribution in total or partial liquidation or any distribution of assets, other than cash, pursuant to a court decree or final administrative order by a government agency ordering distribution of the particular assets.

(c) Distributions made from ordinary income by a regulated investment company or by a trust qualifying and electing to be taxed under federal law as a real estate investment trust are income. All other distributions made by the company or trust, including distributions from capital gains, depreciation, or depletion, whether in the form of cash or an option to take new stock or cash or an option to purchase additional shares, are principal.

(d) Except as provided in subdivisions (a), (b), and (c), all corporate distributions are income, including cash dividends, distributions of or rights to subscribe to shares or securities or obligations of corporations other than the distributing corporation, and the proceeds of the rights or property distributions. Except as provided in subdivisions (b) and (c), if the distributing corporation gives a stockholder an option to receive a distribution either in cash or in its own shares, the distribution chosen is income.

(e) The trustee may rely upon any statement of the distributing corporation as to any fact relevant under any provision of this part concerning the source or character of dividends or distributions of corporate assets.

16879

§ 4808. Bonds and other obligations for payment of money

4808. (a) Bonds or other obligations for the payment of money are principal at their inventory value, except as provided in subdivision (b) for discount bonds. No provision shall be made for amortization of bond premiums or for accumulation for discount. The proceeds of sale, redemption, or other disposition of the bonds or obligations are principal.

(b) The increment in value of a bond or other obligation for the payment of money payable at a future time in accordance with a fixed schedule of appreciation in excess of the price at which it was issued is distributable as income. The increment in value is distributable to the beneficiary who was the income beneficiary at the time of increment from the first principal cash available or, if none is available, when

realized by sale, redemption, or other disposition. Whenever unrealized increment is distributed as income but out of principal, the principal shall be reimbursed for the increment when realized.

16889

§ 4809. Business and farming operations

4809. (a) If a trustee uses any part of the principal in the continuance of a business of which the trustor was a sole proprietor or a partner, the net profits of the business, computed in accordance with generally accepted accounting principles for a comparable business and subject to the provisions of subdivision (c), are income. If a loss results in any fiscal or calendar year, the loss falls on principal and shall not be carried into any other fiscal or calendar year for purposes of calculating net income.

(b) Generally accepted accounting principles shall be used to determine income from an agricultural or farming operation, including the raising of animals or the operation of a nursery, subject to the provisions of subdivision (c).

(c) Subdivisions (a) and (b) are subject to the provisions of Section 4815 and for this purpose any property of such business or agricultural or farming operation shall be deemed to be "property held in such trust" within the meaning of Section 4815.

17008

§ 4810. Natural resources

4810. (a) If any part of the principal consists of a right to receive royalties, overriding or limited royalties, working interests, production payments, net profit interests, or other interests in minerals or other natural resources in, on, or under land, the receipts from taking the natural resources from the land shall be allocated as follows:

(1) If received as rent on a lease or extension payments on a lease, the receipts are income.

(2) If received from a production payment, the receipts are income to the extent of any factor for interest or its equivalent provided in the governing instrument. There shall be allocated to principal the fraction of the balance of the receipts which the unrecovered cost of the production payment bears to the balance owed on the production

payment, exclusive of any factor for interest or its equivalent. The receipts not allocated to principal are income.

(3) If received as a royalty, overriding or limited royalty, or bonus, or from a working, net profit, or any other interest in minerals or other natural resources, receipts not provided for in paragraphs (1) and (2) shall be apportioned on a yearly basis in accordance with this paragraph whether or not any natural resource was being taken from the land at the time the trust was established. The receipts shall be allocated entirely to income or apportioned between income and principal as the trustee in its absolute discretion may determine, but in no event shall more than 27-1/2 percent of the gross receipts (but not to exceed 50 percent of the net receipts remaining after payment of expenses, direct and indirect, computed without allowance for depletion) be added to principal as an allowance for depletion.

(b) This section does not apply to timber, water, soil, sod, dirt, turf, or mosses.

17010

§ 4811. Timber

4811. If any part of the principal consists of land from which merchantable timber may be removed, the receipts from taking the timber from the land shall be allocated entirely to income or apportioned between income and principal as the trustee in its absolute discretion may determine, but in no event shall the amount allocated to principal exceed a reasonable allowance for depletion.

18321

§ 4812. Other property subject to depletion

4812. If the principal consists of property subject to depletion (other than property subject to Section 4810 or 4811), including, when subject to depletion or amortization, leaseholds, patents, copyrights, royalty rights, and rights to receive payments on a contract for deferred compensation, receipts from the property shall be allocated entirely to income, or apportioned between income and principal as the trustee in its absolute discretion may determine, but in no event shall the amount allocated to principal exceed a reasonable allowance for depletion or amortization.

§ 4813. Underproductive property

4813. (a) Except as otherwise provided in this section, a portion of the net proceeds of sale of any part of principal which has not produced an average net income of at least 1 percent per year of its inventory value for more than a year (including as income the value of any beneficial use of the property by the income beneficiary) shall be treated as delayed income to which the income beneficiary is entitled as provided in this section. The net proceeds of sale are the gross proceeds received, including the value of any property received in substitution for the property disposed of, less the expenses, including capital gains tax, if any, incurred in disposition and less any carrying charges paid while the property was underproductive.

(b) The sum allocated as delayed income is the difference between the net proceeds and the amount which, had it been invested at simple interest at 5 percent per year while the property was underproductive, would have produced the net proceeds. This sum, plus any carrying charges and expenses previously charged against income while the property was underproductive, less any income received by the income beneficiary from the property and less the value of any beneficial use of the property by the income beneficiary, is income, and the balance is principal.

(c) If principal subject to this section is disposed of by conversion into property which cannot be apportioned easily, including land or mortgages (for example, realty acquired by or in lieu of foreclosure), the income beneficiary is entitled to the net income from any property or obligation into which the original principal is converted while the substituted property or obligation is held. If within five years after the conversion the substituted property has not been further converted into easily apportionable property, no allocation as provided in this section shall be made.

18529

§ 4814. Charges against income and principal

4814. (a) The following charges shall be made against income:

(1) Ordinary expenses incurred in connection with the administration, management, or preservation of the trust property, including regularly recurring taxes assessed against any portion of the principal, water

rates, premiums on insurance taken upon the interests of the income beneficiary, remainderman, or trustee, interest paid by the trustee, and ordinary repairs.

(2) The trustee in its absolute discretion may make a reasonable allowance for depreciation on property subject to depreciation under generally accepted accounting principles, but no allowance shall be made for depreciation of that portion of any real property used by a beneficiary as a residence.

(3) One-half of court costs, attorney's fees, and other fees on periodic judicial accounting, unless the court directs otherwise.

(4) Court costs, attorney's fees, and other fees on other accountings or judicial proceedings if the matter primarily concerns the income interest, unless the court directs otherwise.

(5) One-half of the trustee's regular compensation, whether based on a percentage of principal or income, unless the court directs otherwise.

(6) All expenses reasonably incurred for current management of principal and application of income.

(7) Any tax levied upon receipts defined as income under this part or the trust instrument and payable by the trustee.

(b) If charges against income are of unusual amount, the trustee may by means of reserves or other reasonable means charge them over a reasonable period of time and withhold from distribution sufficient sums to regularize distributions.

(c) The following charges shall be made against principal:

(1) Trustee's compensation not chargeable to income under paragraphs (4) and (5) of subdivision (a), special compensation of trustees, expenses reasonably incurred in connection with principal, court costs and attorney's fees primarily concerning matters of principal, and trustee's compensation computed on principal as an acceptance, distribution, or termination fee.

(2) Charges not provided for in subdivision (a), including the cost of investing and reinvesting principal, the payments on principal of an indebtedness (including a mortgage amortized by periodic payments of principal), expenses for preparation of property for rental or sale, and, unless the court directs otherwise, expenses incurred in maintaining or defending any action to construe the trust or protect it or the property or assure the title of any trust property.

(3) Extraordinary repairs or expenses incurred in making a capital improvement to principal, including special assessments, but a trustee may establish an allowance for depreciation out of income to the extent permitted by paragraph (2) of subdivision (a) and by Section 4809.

(4) Any tax levied upon profit, gain, or other receipts allocated to principal notwithstanding denomination of the tax as an income tax by the taxing authority.

(5) If an estate or inheritance tax is levied in respect of a trust in which both an income beneficiary and a remainderman have an interest, any amount apportioned to the trust, including penalties, even though the income beneficiary also has rights in the principal.

(d) Regularly recurring charges payable from income shall be apportioned to the same extent and in the same manner that income is apportioned under Section 4805.

Note. In subdivision (c)(2), the last "or" appears where "to" appears in Section 730.13 to correct a typographical error.

21984

§ 4815. Reserve or allowance for depreciation or depletion

4815. (a) The trustee of any trust created by any will or other instrument is not required to set aside a reserve or allowance from trust income for depreciation or depletion of, or to amortize, any property held in such trust unless the instrument expressly requires such a reserve or allowance. Nothing in this part prevents a trustee in its absolute discretion from establishing such reserve or allowance, or from continuing any previous practice of maintaining such reserve or allowance, but the provisions of paragraph (2) of subdivision (a) of Section 4814 as to property used as a residence by a beneficiary and the provisions of Sections 4810, 4811, and 4812 and paragraph (2) of subdivision (a) of Section 4814 as to the amount of such allowance or reserve, if established, apply on and after July 1, 1968.

(b) This section applies to any trust created by a will or instrument executed before, on, or after July 1, 1968.

§ 4816. Application of part

4816. Except as specifically provided in the trust instrument or the will or in this part, this part applies to any receipt or expense received or incurred on or after July 1, 1968, by any trust whether established before, on, or after such date and whether the asset involved was acquired by the trustee before or after such date.

24825

§ 4817. Severability

4817. If any provision of this part or the application thereof to any person or circumstance is held invalid, the invalidity does not affect other provisions of applications of this part which can be given effect without the invalid provision or application, and to this end the provisions of this part are severable.