

First Supplement to Memorandum 84-32

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

This supplement reviews the comments we have received on the staff draft of the Revised Uniform Principal and Income Act (RUIA). Comments of the Executive Committee of the Probate and Trust Law Section of the Los Angeles County Bar Association (LABA Committee), the Executive Committee of the Estate Planning, Trust and Probate Law Section of the State Bar (State Bar Committee), and the California Bankers Association (CBA) are included in letters attached to Memorandum 84-58. An additional analysis of the California Bankers Association is attached as Exhibit 1 to this supplement.

General Comments

The LABA Committee, the State Bar Committee, and the CBA all approve of moving the RUIA to the Probate Code. (See Memorandum 84-58, Exhibit 1, p. 6, and Exhibit 2, p. 3; Exhibit 1, p. 1, attached hereto.)

The staff suggests that the RUIA be located with the provisions governing trustees' powers, since that is what the RUIA provides. In the 1983 draft, the RUIA was tacked on at the end of the main body of the statutes.

Draft § 4801. Effect on tax laws

In the memorandum the staff suggested the elimination of this provision. The LABA Committee appeared to agree with this suggestion in its first letter (see Memorandum 84-58, Exhibit 1, p. 6), but changed its position in the second letter (see Memorandum 84-58, Exhibit 3, p. 11). The LABA Committee's position now is: "If problems will be encountered with the I.R.S. by omitting this Section from the law, then we should retain Section 4801." It states that "apparently some attorneys have reported difficulty convincing agents of the Internal Revenue Service" that the RUIA does not govern the calculation of income for tax purposes.

The staff would like to have some concrete information on this issue. It does not appear that this is a problem encountered in other states, at least as evidenced by the general lack of such provisions in other states' versions of the RUIA. It is also difficult to understand

how draft Section 4801 has any effect on the IRS since it describes only state tax laws. The staff remains unconvinced that this provision is necessary or useful, and suggests its deletion.

Draft § 4802. Definitions

The CBA and the LABA Committee agree that the definition of "trustee" is unnecessary here. (See Memorandum 84-58, Exhibit 3, p. 10; Exhibit 1, p. 1, attached hereto.) The State Bar Committee, however, prefers keeping the definition in Section 4802 "for convenience sake." (See Memorandum 84-58, Exhibit 2, p. 4.)

As a matter of good drafting and also for consistency, the staff continues to recommend deletion of this incomplete definition.

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

All correspondents support the deletion of the inconsistent formulation of the prudent person standard. (See Memorandum 84-58, Exhibit 1, p. 6, Exhibit 2, p. 4; Exhibit 1, p. 1, attached hereto.)

The State Bar Committee supports broadening the "no inference" provision in draft Section 4803(b), in line with the staff recommendation in the memorandum. The staff prefers both the Texas and Nebraska versions (set out on page 3 of the memorandum) to California law. The State Bar Committee prefers the Nebraska version. The staff is content to go along with the State Bar Committee and recommend the Nebraska version. Hence, draft Section 4803(b) would read:

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

Draft § 4804. Principal and income

The CBA agrees with the staff recommendation that subdivision (c) be split from the definitional provisions in subdivisions (a) and (b). (See Exhibit 1, p. 1, attached hereto.)

On page 4 of the memorandum the staff asked whether the definition of income should be revised to include "proceeds of insurance from the loss of income" as was done in Wisconsin and Nebraska. The CBA suggests that the meaning of such a change would not be clear. (Id.) The CBA finds acceptable the addition of "income added to and held as principal" to the definition of "principal." (Id. at p. 2.) The staff has no firm

recommendation in this area, but we would not suggest adding or revising language in the RUPIA unless the Commission thinks it would be an improvement.

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

There is disagreement on the desirability of continuing the California variation of the RUPIA regarding the date of accrual of income and its apportionment. (See the discussion in the memorandum on pp. 4-6.) The State Bar Committee supports retention of the existing California rule and seconds the staff's suggestion that apportionment under this rule has the virtue of administrative simplicity. (See Memorandum 84-58, Exhibit 2, p. 4.) On the other hand, the CBA cites simplicity as the reason for adopting the rule of the RUPIA in this regard. (See Exhibit 1, p. 2, attached hereto.) According to the CBA the "allocation of payments with respect to estates and inter vivos trusts is logical and simple."

The staff has nothing to add to the discussion in the memorandum. In sum, the choice between the California variation and the RUPIA rule is between administrative simplicity and what appears to be more just in some types of cases. The memorandum also notes that California appears to stand alone among RUPIA states in retaining the common law rule.

Draft § 4807. Corporate distributions

The memorandum at page 6 mentions variations in other states in this provision of the RUPIA. The CBA sees no reason to change existing law. (See Exhibit 1, p. 2, attached hereto.)

Draft § 4808. Bonds

The State Bar Committee would retain the existing "no amortization" rule for bond premiums on the ground that this is a better general rule since trustors can not be relied upon to draft around a contrary general rule. (See Memorandum 84-58, Exhibit 2, p. 4.) This comment does not deal with the substance of the criticism of the "no amortization" rule. As noted on pages 6 and 7 of the memorandum, this rule is inconsistent with another nonuniform provision set forth in draft Section 4815 which provides that a trustee is not prevented from setting aside a reserve for depreciation or amortization. Nor did the State Bar Committee answer the objection that the "no amortization" rule is unfair to remaindermen. The CBA suggests deleting the "no amortization" rule,

although it is stated that CBA has "no experience with the problem stated regarding the unfair treatment of remaindermen." (See Exhibit 1, p. 2, attached hereto.) The staff believes that the Commission should consider this problem.

Draft § 4809. Business and farming operations

As to the language on "generally accepted accounting principles", the CBA says that there is no problem and that the substitute language of some other states does not accomplish a meaningful change. (See Exhibit 1, p. 2, attached hereto.) This supports the staff conclusion that there does not seem to be any real problem with this language in California.

Both the State Bar Committee and the LABA Committee support the Wisconsin-Nebraska variation that provides for carrying forward losses of business and farming operations. (See Memorandum 84-58, Exhibit 2, pp. 4-5, Exhibit 3, p. 11.) The staff agrees with the analysis of the State Bar Committee and recommends the deletion of the "no carry forward" rule. The Commissioners should read the analysis of the State Bar Committee on pages 7 and 8 of Exhibit 2 attached to Memorandum 84-58.

Draft § 4810. Disposition of natural resources

The State Bar Committee argues for retention of the trustee's discretion to allocate up to 27-1/2% for depletion. (See Memorandum 84-58, Exhibit 2, p. 5.) The staff has no objection to the discretionary allocation of a percentage of gross receipts for depletion, but finds it nonsensical to retain the 27-1/2% figure. The CBA supports the staff suggestion to replace this figure with general language referring to the portion of gross receipts allowed as a deduction for depletion in computing taxable income for federal income tax purposes. (See Exhibit 1, p. 3, attached hereto.) As noted in another CBA letter, more general language would anticipate changes made in future tax legislation. (See Memorandum 84-58, Exhibit 4, p. 12.)

Draft § 4811. Timber

Both the State Bar Committee and the CBA support the suggestion that the Oregon approach, which treats timber as other natural resources, would be desirable in California. (See Memorandum 84-58, Exhibit 2, p. 5; Exhibit 1, p. 3, attached hereto.)

The State Bar Committee also suggests that:

[T]imber on the property at the time the trust is established should be deemed principal. Consideration should be given to developing some means of segregating income from principal without the necessity of an appraisal at the time the trust is established. Perhaps a formula approach based on average harvest age for the type of tree cut could be developed. Allocating all timber to principal with a factor for unproductive property would be reasonable.

The staff does not have any particular reaction to this suggestion, although we would be happy to receive a proposed draft from the proponents.

Draft § 4813. Underproductive property

The staff raised the question whether the 5% figure for an adjustment for underproductive property is too low. (See the memorandum on page 10.) The State Bar Committee finds this to be a satisfactory level as a general rule and suggests that a higher level would have a "major impact" on trusts with farm property. (See Memorandum 84-58, Exhibit 1, p. 5.) The CBA is receptive to a floating standard as discussed by the staff in the memorandum, but also notes that it is unaware of any problems with this provision. (See Exhibit 1, p. 3, attached hereto.) If there is no particular interest in pursuing this question, the staff is content to leave this section as it is.

Draft § 4814. Charges against principal and income

Both the State Bar Committee and the CBA find the flexible rule of allocating charges provided by existing law to be desirable. (See Memorandum 84-58, Exhibit 2, p. 5; Exhibit 1, p. 3, attached hereto.) The staff has not suggested any change in this provision.

Draft § 4815. Reserve for depreciation or depletion

The staff questions the need to continue this provision because it is primarily a transitional provision dating back to 1968. Perhaps experts in this area can tell us whether this provision is still important. The CBA, for one, suggests some revision to avoid the need to separately invest or account for reserves or allowances under this section. (See Memorandum 84-58, Exhibit 4, p. 12; Exhibit 1, pp. 3-4, attached hereto.) The staff does not see that Section 4815 requires any separate investment or accounting, however. In any event, the staff tends to think it would be best to eliminate this provision, unless a strong case can be made for its retention.

Draft § 4816. Application of [part]

Both the State Bar Committee and the LABA Committee suggest that this provision applying the RUIA to all trusts unless the trust provides otherwise be moved to the beginning of the California RUIA. (See Memorandum 84-58, Exhibit 2, pp. 3-4, Exhibit 3, p. 10.) The CBA finds that the section "does no real harm." The staff takes these comments to mean that it is desirable to make it clear at the outset of this set of provisions that they are subject to a contrary intention expressed in the trust instrument. The staff agrees that this must be made clear. However, it should be noted that draft Section 4803 makes abundantly clear that the RUIA rules are subject to the control of the trust instrument.

Draft § 4817. Severability

The CBA agrees with the staff that this provision is unnecessary as a duplication of Probate Code Section 11. (See Exhibit 1, p. 4, attached hereto.)

Respectfully submitted,

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Staff Counsel

EXHIBIT 1

6/18/84 84-32

California Bankers Association

Comments on Memorandum 84-32

The following comments are offered in analysis of Memorandum 84-32, the California version of the Revised Uniform Principal and Income Act:

1. The recommendation to move the Act to the Probate Code from the Civil Code is strongly supported. Because of the fact that the Act has impact on trustees, trusts and beneficiaries, it should be located in the Probate Code.
2. Draft §4802: Since the Act will now be found in the Probate Code, it does not appear necessary to include a definition of "trustee" in this section when an acceptable definition appears elsewhere in the Code.
3. Draft §4803: We agree that the "prudent man" provision of §4803(a)(3) is inappropriate since it is not an exact restatement of the existing language of Civil Code Section 2261(1). In any event, if the section is deleted entirely from §4803, the standard of Section 2261(1) will apply. For these reasons, the prudent man language should be deleted.
4. Draft §4804: We agree that subdivision (c) should be removed from this section because it is not a definition. The addition to the definitions of "proceeds of insurance from the loss of income" is not clear as to its meaning. The

addition of "income added to and held as principal" is acceptable since it is an obvious item to be treated, and its inclusion certainly should not create a problem.

5. Draft §4805: In the interest of simplicity, it is recommended that the provision of the Revised Uniform Principal and Income Act (RUPIA) be adopted and made a part of the California version of the Act. The allocation of payments with respect to estates and inter vivos trusts is logical and simple.
6. Draft §4807: We know of no reason to change the provisions of the RUPIA as other states have done and we recommend that the section be continued in its current form.
7. Draft §4808: We have no experience with the problem stated regarding the unfair treatment of remaindermen. However, we prefer that the correction of the problem be made by deleting the "no amortization" rule rather than by leaving the solution in the hands of the person drafting the trust instrument and by relying on the trustor's awareness of the potential problem.
8. Draft §4809: We know of no problem arising out of the "generally accepted accounting principles" language. Furthermore the substitute language does not appear to make a meaningful change to the existing language.

9. Draft §4810: We agree that the specific percentage set out in the existing provision should be changed to more general language. We suggest that a reasonable standard be incorporated into this provision.
10. Draft §4811: The inclusion of timber in Draft Section 4810 and the deletion of draft Section 4811 appears to be a simple and reasonable suggestion.
11. Draft §4813: We are unaware of any problems with the provisions of this Section. However, it does appear that the percentages are potentially low and that a "floating standard" may be more reasonable.
12. Draft §4814: The allocation of trustee's regular compensation and extraordinary expenses between income and principal appears to be an equitable method of handling such charges. An income beneficiary and a remainderman share these expenses equally. We are not aware of significant increased burdens on trustees because of the flexible rule of allocation.
13. Draft §4815: We recommend that language be added to this section which will eliminate the burden of holding reserves or allowances separately. This special treatment is unnecessary and creates administrative problems. The

following sentence is suggested to be inserted after the first sentence of the existing section: "Such reserve or allowance need not be separately invested or accounted for."

14. Draft §4816: We in general agree that there is no real need for the retention of this provision. However, the new law will not apply to trusts which specifically reference the version of the law in effect on the date of the trust instrument. For this reason, the section does no real harm.
15. Draft §4817: We agree that the provision of this section is unnecessary since it is duplicative of Section 11 of the Probate Code.