Study L-649 March 9, 1998

Memorandum 98-19

Uniform Principal and Income Act: Preliminary Considerations

Earlier this year, the Commission was asked by the State Bar Estate Planning, Trust and Probate Law Section to study the new Uniform Principal and Income Act (UPAIA or "the Act"), and the Commission agreed to do so on an accelerated basis.

The UPAIA was approved by the National Conference of Commissioners on Uniform State Laws last August — a copy of the Act is attached to this memorandum. (Note that the final copy of the UPAIA has not yet been printed by NCCUSL, but our sources have been kind enough to furnish the attached candidate final copy for the Commission's review. We are using "UPAIA" to distinguish the new principal and income act from the recent Uniform Prudent Investor Act, now known as UPIA.)

A number of significant issues have been raised, as a review of the attached letters will demonstrate:

At the March meeting, we plan to review the major points of contention. The Commission should hear directly from the California Bankers Association and other interested persons, and get an idea whether the problems can be worked out. We expect to receive materials from the State Bar Estate Planning, Trust and Probate Law Section Executive Committee before the meeting and will forward them in a supplement.

OVERVIEW OF COMMENTARY

In the memorandum attached to David Lauer's letter, the California Bankers Association (CBA) reviews each section of the UPAIA. (See Exhibit pp. 1-13.) With several important exceptions, the CBA concludes that the Act's provisions would be either objectionable or unnecessary.

The focus of opposition is the trustee's power to make adjustments between principal and income under Section 104. In 11 numbered points, CBA outlines serious problems, including the difficulty of determining relevant factors precedent to making an adjustment, the risk of exposure to liability from hindsight second-guessing, the cost and time involved in reviewing and determining the propriety of adjustments, the likely need to seek court approval of adjustments, complex tax problems resulting from adjustment, increased potential for hostility among beneficiaries and between beneficiaries and trustees, and burdens that would be caused by applying the new rule to existing trusts. (See Exhibit pp. 4-6.) In several areas relating to particular allocation rules, however, CBA believes the Act proposes useful additions or clarification of California law. (See, e.g., Exhibit pp. 8-9 (§§ 401, 403) , 11-13 (§ 425, 427, 501-502).)

The American Bankers Association letter concentrates on the trustee's power to adjust between principal and income under (now) Section 104. (See Exhibit pp. 15-36.) The Association's major complaints are that the UPAIA "gives no standards for the trustee to follow in exercising discretion," thus defeating the safe-harbor aspect of the Act, creating a potential battleground of litigation among beneficiaries and between beneficiaries and trustees, and leading to increased costs, delays, and complexities of trust administration. The Association's "discussion draft memorandum" dates from June 1995 and is based on Section 601, which has been substantially redrafted in the final UPAIA Section 104. We do not know to what extent the detailed criticisms in the draft memorandum have been met in the final version of the Act. However, Mr. Misheff's February cover letter affirms that the fundamental objections remain.

Preliminary remarks from the State Bar Estate Planning, Trust and Probate Law Section Executive Committee also express concern over the adjustment power. (Letter from James Deeringer, Jan. 6, 1998.)

RELATION TO UNIFORM PRUDENT INVESTOR ACT

According to its Prefatory Note, one purpose of the new UPAIA is to "provide a means for implementing the transition to an investment regime based on principles embodied in the Uniform Prudent Investor Act, especially the principle of investing for total return rather than a certain level of 'income' as traditionally perceived in terms of interest, dividends, and rents."

The Uniform Prudent Investor Act of 1994 (UPIA) was enacted in California on Commission recommendation in 1995. See *Uniform Prudent Investor Act*, 25 Cal. L. Revision Comm'n Reports 543 (1995) (a copy of the Commission's recommendation and the UPIA is attached to this memorandum in the form of a "Staff Report"). Enactment of the California version of the UPIA followed a lengthy and detailed process of study and negotiation involving the Commission, CBA committees, State Bar representatives, and Prof. Edward Halbach, who is a Commission consultant and the Reporter for the Restatement (Third) of Trusts: Prudent Investor Rule (1992).

As mentioned in the CBA memorandum, California has had a portfolio approach to trust investments since 1984. (See Exhibit p. 4.) The first incarnation in the statutes (former Civ. Code § 2261(a)(1)) was phrased as a qualification on the prudent person rule as applied to investment and management decisions. It was intended to modernize the way investment decisions were judged by the courts. (See *Selected 1986 Trust and Probate Legislation*, 18 Cal. L. Revision Comm'n Reports 1201, 1241 (1986).) The 1984 bill addressed the problem arising where a trustee could be surcharged for losses to an asset that formed part of a balanced portfolio without credit for the gains in other assets. The Trust Law, enacted on Commission recommendation in 1986, restated this standard in somewhat broader terms in Probate Code Section 16040(b).

Section 16040 and related provisions were thoroughly reconsidered and revised in the course of enacting the UPIA in 1995. While it is correct to say that California has had a portfolio approach for some time, the "prudent investor" standard in place since 1996 is not the same as the 1984 rule. The differences are summarized in the Commission's recommendation on the UPIA set out in the attached Staff Report (green cover) on pp. 1-3. The 1985-1995 portfolio rule, while representing an important step, was more of a clarifying statement tacked on to the traditional prudent person rule than an obvious change in approach. The UPIA operative in 1996 is much more detailed and imposes a set of affirmative duties related to investments and management of trust assets, separate from the general standard of care in Section 16040. (For the text of the California UPIA, see the attached Staff Report, pp. 7-15.)

The law makes conformance with the prudent investor rule a positive duty owed to beneficiaries. Prob. Code § 16046. The portfolio rule in Section 16047 provides more detail and different standards than the earlier rule. It envisions a different way of planning and reviewing investments and management decisions. It places emphasis on a process of evaluating relevant circumstances beyond the confines of the prudent person rule in prior law. The new law recognizes the appropriate role of evaluating risk in making investment decisions. The UPIA provides default rules, meaning that a settlor can provide different standards, as recognized in Section 16046(b). Boilerplate statements of trustees' authority, such as to make "legal investments" or investments permissible under the prudent man rule, are interpreted as referring to the prudent investor rule under Section 16053. The prudent investor rule is applicable to all private trusts, although not to decisions made before the operative date, as provided in Section 16054.

The problem addressed in Section 104 of the UPAIA is that proper application of the prudent investor rule is likely to lead to an imbalance in allocations between principal and income accounts in certain circumstances. The Prefatory Note summarizes the need for adjustment and its operation as follows:

> The law of trust investment has been modernized. …. Now it is time to update the principal and income allocation rules so the two bodies of doctrine can work well together. This revision deals conservatively with the tension between modern investment theory and traditional income allocation. The starting point is to use the traditional system. If prudent investing of all the assets in a trust viewed as a portfolio and traditional allocation effectuate the intent of the settlor, then nothing need be done. The Act, however, helps the trustee who has made a prudent, modern portfolio-based investment decision that has the initial effect of skewing return from all the assets under management, viewed as a portfolio, as between income and principal beneficiaries. The Act gives that trustee a power to reallocate the portfolio return suitably. To leave a trustee constrained by the traditional system would inhibit the trustee's ability to fully implement modern portfolio theory.

A simple illustration of the problem is given in the comment to Section 104:

> **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 factors in Section 104(b), T may transfer cash from principal to income to the extent T considers it necessary to increase the amount distributed to the income beneficiary.

This in microcosm shows the need for the adjustment rule.

The staff speculates that some of the resistance to the adjustment power in Section 104 reflects discomfort with the prudent investor rule itself. We believe the prudent investor rule is intended to require more analysis and careful decisionmaking than under traditional rules. At a recent panel discussion entitled "The Minefield of Living Trust Practice in the Wake of the California Prudent Investor Act" (held Jan. 26, 1998, Hyatt Regency at SFO), questions from the floor suggested to the staff that many practitioners are either unacquainted with the prudent investor rule, or are reluctant to accept it despite its theoretical elegance. The speakers on the panel repeatedly emphasized the important and beneficial aspects of the rule. Perhaps as the process of educating estate planners and trustees continues, the comfort level will rise and the new language and concepts will not seem so difficult.

At this stage we are not prepared to suggest specific solutions to the problems raised by CBA and the American Bankers Association. The staff would be interested in receiving comments on how to reconcile the prudent investor rule with the current RUPIA or with the UPAIA absent some power of adjustment. (There are some suggestions in the American Bankers Association memorandum, but these were directed to the 1995 version of the adjustment rule, and the staff has not had time to analyze them in connection with the new rule in Section 104.)

Several ameliorating rules might serve to address the bankers' concerns. For example, clearer or greater protection from liability for adjustment decisions could be investigated. We should also look at more explicit standards limiting the availability of the adjustment power or greater scope for the authority under Section 104(e) to release the adjustment power.

RETROACTIVITY

The difficulties perceived with the adjustment section may be magnified by the rule applying UPAIA to existing all trusts and estates, "except as otherwise expressly provided in the will or terms of the trust or in this Act." UPAIA § 605. Extremely few estate planners would have anticipated the content of the Act in order to override or adjust its application, assuming they would have wanted to do so. In order to place the CBA (and American Bankers Association) criticisms in perspective, we would like CBA to consider to what extent their objections stem from the prospect of applying the adjustment power retroactively.

On the other hand, does it make sense to apply the prudent investor rule retroactively and make the UPAIA prospective only? Perhaps part of the problem, assuming other important issues can be addressed, is the prospect of the burden of reviewing all trust accounts under the new law. A deferred operative date or grace period might help in this regard.

OTHER ISSUES

The other reason for the new UPAIA is to modernize the law as reflected in the 1962 RUPIA. The Prefatory Note to the UPAIA summarizes:

> Revision is needed to support the now widespread use of the revocable living trust as a will substitute, to change the rules in [RUPIA] that experience has shown need to be changed, and to establish new rules to cover situations not provided for in the old Acts, including rules that apply to financial instruments invented since 1962.

California enacted the original Uniform Principal and Income Act (1931) in 1941 and replaced it with the RUPIA (1962) in 1967. This law was revised in several respects when the Trust Law was enacted on Commission recommendation in 1986. (For background and a description of the 1986 changes, see *Selected 1986 Trust and Probate Legislation*, 18 Cal. L. Revision Comm'n Reports 1201, 1249-52 (1986).) One or two minor amendments have been made since that time. The current California RUPIA, with Commission Comments, is attached as Exhibit pp. 37-47.

The modernizing and technical revisions proposed by UPAIA are summarized in the Prefatory Note on pages 1-2 of the attached copy of the Act.

Much of the CBA memorandum deals with concerns other than the adjustment power. The staff has not studied these issues in any detail, but our initial reaction is that many of the CBA concerns can be dealt with. Some of them are purely technical, and can be handled without any problem. For example, most of the issues in the CBA memorandum concerning definitions (Section 102, see Exhibit pp. 2-4) can be resolved. Uniform acts need to be self-sufficient, so they include definitions that are generalized in the Probate Code. We routinely revise uniform acts to omit or refine definitions.

There are some important policy issues raised by some of the definitions, however, such as "terms of a trust":

> (12) "Terms of a trust" means the manifestation of the intent of a settlor or decedent with respect to the trust, expressed in a manner that admits of its proof in a judicial proceeding, whether by written or spoken words or by conduct.

CBA finds this definition (see Exhibit p. 3) to be

> confusing and objectionable. Under this standard, a writing other than the trust agreement, or spoken words or conduct, could be contrary to the express terms of the governing instrument and yet control over the express terms of the governing instrument. The resolution of a trust construction lawsuit is dependent upon the facts and circumstances of the particular case. Under this standard, a trustee cannot conclusively rely on the provisions of the governing instrument absent a litigated court determination.

This comment raises an important issue that also troubled the staff when we read the UPAIA.

In areas where the CBA finds the proposed new language "not objectionable" or is indifferent — and there are quite a few of these — we assume that if the major problems can be resolved, these pieces of the Act can follow as part of a more or less complete package.

Respectfully submitted,

Stan Ulrich
Assistant Executive Secretary

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December 19, 1997

Bion Gregory, Commissioner
Uniform Commission on State Laws
State Capital
Room 3021
Sacramento, CA 95814

Re: Comments by California Bankers Association on Revision of the Uniform Principal and Income Act

Dear Mr. Gregory:

As chairman of the Trust Governmental Affairs Committee of the California Bankers Association, I am enclosing a summary of initial comments, concerns and questions of the Committee in relation to the proposed revision of the Act.

Based on its review, the Committee must at this time take the position that if the revision is proposed as legislation in its current form, the California Bankers Association will oppose such legislation. The Committee is, however, available to work with you to address the issues identified in the attachment to reach a mutually agreeable revision to the Act.

Please review the attached. The Committee will be available to meet with you in the new year to discuss the proposal. Please contact me at your convenience so that we may begin discussions. I look forward to hearing from you.

Sincerely,

David W. Lauer

Cc:Trust State Government Affairs Committee, w/encl.
Maurine Padden, CBA, w/encl.

CALIFORNIA BANKERS ASSOCIATION COMMENTS TO THE REVISION OF THE UNIFORM PRINCIPAL AND INCOME ACT (THE "1997 ACT")

ARTICLE 1. DEFINITIONS AND FIDUCIARY DUTIES

SECTION 102. DEFINITIONS

Section 102 of the 1997 Act contains thirteen definitions. Sections 16301 and 16303 of the California Uniform Principal and Income Act (The "California Act"), and other sections in the California Probate Code, contain numerous definitions. The following are comments on each of the thirteen definitions contained in the 1997 Act:

1. Accounting Period

A definition for "accounting period," is not objectionable but is not necessary or helpful.

2. Beneficiary

The term "beneficiary", for purposes of a trust, is defined under Probate Code Section 24(c) to mean a person who has any present or future interest, vested or contingent. An additional definition of the term "beneficiary" is unnecessary.

3. Fiduciary

The term "fiduciary" is defined under Probate Code Section 39 to mean a personal representative, trustee, guardian, conservator, or other legal representative. An additional definition of the term "fiduciary" is unnecessary.

4. Income

The term "income" is defined under Probate Code Section 16303(a). The definition of "income" in the California Act, with its reference to various sections in the California Act, is preferable to the general language used by the 1997 Act.

5. Income Beneficiary

The term "income beneficiary" is defined under Probate Code Section 16301 (a). There is no apparent reason to differentiate between "income" and "net income", as does the 1997 Act. The California Act definition is preferable.

6. Income Interest

The inclusion of a definition of "income interest", is not objectionable but it is neither necessary nor helpful since we do not support the adoption of the sections of the 1997 Act that use this term.

7. Mandatory Income Interest

The inclusion of a definition of "mandatory interest" is not objectionable, but it is neither necessary nor helpful because we do not support the adoption of the sections of the 1997 Act that use this term.

8. Net Income

The inclusion of a definition of "net income" is not objectionable but it is neither necessary nor helpful because we do not support the adoption of the sections of the 1997 Act that use this term.

9. Person

The term "person" is defined under Probate Code Section 56 to mean an individual, corporation, government or governmental subdivision or agency, business trust, estate, trust partnership, limited liability company, association, or other entity. An additional definition of "person" is unnecessary. It should be noted that the definition of "person" under the 1997 Act excludes government and a governmental subdivision, agency or instrumentality.

10. Principal

The term "principal" is defined under Probate Code Section 16303(b). The definition of "principal" under both the California Act and the 1997 Act is technically deficient since a portion of the principal often is distributed prior to the termination of the trust to different individuals from those who ultimately receive the principal upon termination of the trust. One example is a discretionary principal distribution to the income beneficiary.

11. Remainder Beneficiary

The term "remainder beneficiary" is defined under Probate Code Section 16301(c). Although the 1997 Act's definition of "remainder beneficiary" is not objectionable, the California Act's definition is preferable.

12. Terms Of A Trust

This definition is confusing and objectionable. Under this standard, a writing other than the trust agreement, or spoken words or conduct, could be contrary to the express terms of the governing instrument and yet control over the express terms of the governing instrument. The resolution of a trust construction lawsuit is dependent upon the facts and circumstances of the particular case. Under this standard, a trustee cannot conclusively rely on the provisions of the governing instrument absent a litigated court determination.

The comment to Section 102(12) states that this term replaces "governing instrument" to make clear that the Act applies to oral trusts as well as written trusts. However, the implication of the language could extend beyond the stated goal. Further, the issue of what constitutes a valid trust under California law is covered by Probate Code Sections 82(a) and 15200 - 15212.

13. Trustee

The term "trustee" is defined under Probate Code Section 84. It is the same definition as contained in the 1997 Act.

CONCLUSION: Sections 16301 and 16303 should remain in their present form. None of the definitions contained in Section 102 of the 1997 Act should be adopted in California.

SECTION 103. FIDUCIARY DUTIES: GENERAL PRINCIPLES

Probate Code Section 16302 is clear and understandable. The section already addresses most of the concepts contained in the corresponding section of the 1997 Act. We find many parts of Section 103 to be confusing. Further, Section 103 is objectionable to the extent that it incorporates the power to adjust granted by *Section 104* of the 1997 Act.

CONCLUSION: Section 16302 of the California Act should remain in its present form. None of the language of Section 103 of the 1997 Act should be adopted in California.

SECTION 104. TRUSTEE'S POWER TO ADJUST

Section 104 of the 1997 Act is the most objectionable section from a trustee's standpoint. Section 104 authorizes the trustee, in its discretion, to make adjustments between income and principal to the extent that the trustee believes that it is equitable to do so, after taking into account "all" factors relevant to the trust and its beneficiaries. The section does not specify what "all" such factors are, but includes a list of factors that must be considered "to the extent they are relevant". Adjustments cannot be made under certain circumstances, including circumstances where certain adverse tax consequences could result, which is a determination to be made by the trustee.
The Comment to Section 104 states that the purpose of the section "is to enable a trustee to select investments based on 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 and dividends."

We disagree with the premise that a trustee needs to have a power to reallocate receipts between income and principal in order to benefit fully from the Uniform Prudent Investor Act's emphasis on the total return approach of modem portfolio theory. Most of the investment concepts which comprise the Uniform Prudent Investor Act and the modem portfolio theory have been the law in California for approximately fifteen years, and a trustee's inability to reallocate receipts has not caused any significant problems in the administration of trusts during that time. However, the adoption of Section 104 will result in very serious problems, some of which are outlined below:

1. A trustee must consider "all" of the relevant factors. Reasonable minds can differ on what factors are relevant, and the trustee could be second-guessed in hindsight. For example, one of the factors that must be considered is "the actual and anticipated effect of economic conditions on principal and income and effects of inflation and deflation." Aside from the cost and administrative time to prepare such an analysis, the nature of this type of analysis is highly subjective and, therefore, could subject the trustee to attack.

2. Another relevant factor is the settler's intent. Often, if not usually, the trustee will have insufficient information regarding the settler's intent, other than whatever is reflected in the governing instrument.

3. An adjustment is precluded if certain adverse tax consequences could result. The trustee would need to retain counsel at the expense of the trust to advise the trustee each time a determination must be made.

4. A trustee who is not a beneficiary (i.e., a bank) cannot make an adjustment if the trustee will benefit directly or indirectly from the adjustment. Thus, no adjustment can ever be made that benefits principal if the trustee's fees are based, in whole or in part, on the value of the principal. Therefore, in most cases, a bank trustee could make an adjustment that would benefit the income interest to the detriment of the principal interest. This result does not advance equitable principles.

5. Currently, there are two primary areas of potential liability with respect to investments. The first relates to allocation. A trustee generally has a duty to diversify the portfolio, and a trustee could incur liability for the failure to properly diversity the portfolio. The second relates to the purchase of a particular asset. It is difficult for a beneficiary to assert a successful claim against a trustee if the portfolio has been reasonably diversified and an investment was neither prohibited by the governing instrument nor a type which is inappropriate as a trust investment. If Section 104 is adopted, there will now be a third component: adjustment of receipts between income and principal. This provision will add a complex factor to the investment equation and, given its subjective nature and its direct impact on the beneficiaries, will promote investment-related controversies.

6. The additional time and effort involved to review and make determinations on adjustment issues will be administratively burdensome and costly.

7. To protect trustees from future claims, often it will be prudent to petition the court for instructions with respect to a proposed reallocation adjustment. The result will be additional expense to the trust account and a burden on the probate court, thereby causing a court backlog. In the early 1980's, the California Probate Code was amended to allow the removal of testamentary trusts from the court's continuing

jurisdiction. Subsequently, the law was amended to permit personal representatives under certain circumstances to make decisions without court involvement. In recent years, it has generally been the philosophy to attempt, to the extent possible, to permit administration without court involvement. The adoption of Section 104 is inconsistent with this philosophy because it will result in trustees seeking more court involvement to approve their decisions to allocate or not allocate under Section 104.

8. There could be tax implications resulting from an adjustment that may be unclear or contested by the affected beneficiaries.

9. To give a trustee the power granted by Section 104 would increase the potential for hostility between the trustee and the beneficiaries, and among beneficiaries.

10. Investment personnel may use Section 104 as justification for investing the portfolio heavily into equities, on the premise that some of the principal can be reallocated to income to compensate for the lower income return on equities. Following this investment philosophy could result in a failure to diversify between types of investments (equity vs. fixed income).

11. Trusts that are currently irrevocable and which are governed by California's current Principal and Income Act were established with the understanding that the trustee did not have the power to adjust and, unless otherwise provided in the governing instrument, that the portfolio would be diversified. To give the trustee the power to reallocate receipts between income and principal, and institute a different investment standard, will in many cases be in violation of the settler's intent.

In conclusion, we strongly oppose the adoption of Section 104 of the 1997 Act in any form.

ARTICLE 2. DECEDENT'S ESTATE OR TERMINATING INCOME INTEREST

SECTION 201. DETERMINATION AND DISTRIBUTION OF NET INCOME

The corresponding provisions to these sections in the 1997 Act is Articles 2 and 3, consisting of Sections 201, 202, 301, 302 and 303.

These sections under the California Act are clear, concise and fair to both income and remainder beneficiaries. The corresponding sections of the 1997 Act appear confusing.

CONCLUSION: Sections 16304, 16305 and 16314 of the California Act should remain in their present form. None of the language of Sections 201, 202, 301, 302 and 303 should be adopted in California.

SECTION 202. DISTRIBUTION TO RESIDUARY AND REMAINDER BENEFICIARIES

The corresponding provisions to these sections in the 1997 Act is Articles 2 and 3, consisting of Sections 201, 202, 301, 302 and 303.

These sections under the California Act are clear, concise and fair to both income and remainder beneficiaries. The corresponding sections of the 1997 Act appear confusing.

CONCLUSION: Sections 16304, 16305 and 16314 of the California Act should remain in their present form. None of the language of Sections 201, 202, 301, 302 and 303 should be adopted in California.

ARTICLE 3. APPORTIONMENT AT BEGINNING AND END OF INCOME INTEREST

SECTION 301. WHEN RIGHT TO INCOME BEGINS AND ENDS

The corresponding provisions to these sections in the 1997 Act is Articles 2 and 3, consisting of Sections 201, 202, 301, 302 and 303.

We believe that these sections under the California Act are clear, concise and fair to both income and remainder beneficiaries. We believe that the corresponding sections of the 1997 Act appear confusing.

CONCLUSION: Sections 16304, 16305 and 16314 of the California Act should remain in their present form. None of the language of Sections 201, 202, 301, 302 and 303 should be adopted in California.

SECTION 302. APPORTIONMENT OF RECEIPTS AND DISBURSEMENTS WHEN DECEDENT DIES OR INCOME INTEREST BEGINS

The corresponding provisions to these sections in the 1997 Act is Articles 2 and 3, consisting of Sections 201, 202, 301, 302 and 303.

These sections under the California Act are clear, concise and fair to both income and remainder beneficiaries. The corresponding sections of the 1997 Act appear confusing.

CONCLUSION: Sections 16304, 16305 and 16314 of the California Act should remain in their present form. None of the language of Sections 201, 202, 301, 302 and 303 should be adopted in California.

SECTION 303. APPORTIONMENT WHEN INCOME INTEREST ENDS

The corresponding provisions to these sections in the 1997 Act is Articles 2 and 3, consisting of Sections 201, 202, 301, 302 and 303.

These sections under the California Act are clear, concise and fair to both income and remainder beneficiaries. The corresponding sections of the 1997 Act appear confusing.

CONCLUSION: Sections 16304, 16305 and 16314 of the California Act should remain in their present form. None of the language of Sections 201, 202, 301, 302 and 303 should be adopted in California.

ARTICLE 4. ALLOCATION OF RECEIPTS DURING ADMINISTRATION OF TRUST

PART 1. RECEIPTS FROM ENTITIES

SECTION 401. CHARACTER OF RECEIPTS

The corresponding provision to Section 16306 of the California Act is Section 401 of the 1997 Act. Section 16306 relates to corporate, mutual fund and REIT distributions. Section 401 expands its application to entities such as partnerships, joint ventures, limited liability companies and common trust funds.

Although Section 16306 works well with respect to the kind of distributions covered by the section, it would be useful to have uniform rules applicable to the entities specified in Section 401. Further, the language of Section 401 is generally acceptable. However, one matter of concern is Section 401 (f), which provides as follows:

"A trustee may rely upon a statement made by an entity about the source or character of a distribution if the statement is made at or near the time of distribution by the entity's board of directors or other person or group of persons authorized to exercise powers to pay money or transfer property comparable to those of a corporation's board of directors."

See Section 16306(e) for the corresponding language of the California Act. Note that this language is deficient because it refers only to distributions from corporations, thereby omitting mutual funds and REITS.

With respect to Section 401(f), the restriction that the entity's statement be made "at or near the time of distribution" is objectionable. Further, it would be better for a trustee if the language allowed a trustee to rely on a statement made by the entity either in documentation that accompanies the distribution or, if none, by a representative of the corporation whom the trustee reasonably believes can provide the desired information.

Furthermore, it is desirable that there be certainty as to the treatment of distributions if there is no statement or information which is readily ascertainable to the trustee. In such cases, a distribution may be allocated to principal.

Also, there is a potential conflict between Section 401(d)(2) and Section 401(f). If the total amount received in a distribution or series of related distributions is greater than

20% of the entity's gross assets but the entity indicates that the distribution or distributions is not a partial liquidation, which prevails.

CONCLUSION: We support amendment of Section 16306 of the California Act to conform with Section 401 of the 1997 Act, subject to changes in the language of Section 401(f) to provide greater trustee protection for acting upon the representations of an entity's representative and clarification of the potential conflict between Section 401(d)(2) and Section 401(f).

SECTION 403: BUSINESS AND OTHER ACTIVITIES CONDUCTED BY TRUSTEE

Section 16308 of the California Act prescribes general standards when the trustee is engaged in an unincorporated business. For example, net profits are allocable to income. The comparable section of the 1997 Act, Section 403, gives the trustee broad discretion to allocate receipts between income and principal. Section 403 also permits the trustee to account separately for the business activity rather than in its standard accounting.

In this instance, we believe that both the discretion given to the trustee with respect to the allocation of receipts, and the ability to account separately, are beneficial factors. The discretion would only apply if the business activity were accounted for separately.

We support replacing Section 16308 with Section 403 subject to two changes to Section 403(c). First, (c)(4) should be supplemented to include a definition of when this activity constitutes a business. The standard prescribed under Section 16222(b) of the California Probate Code should be adopted. Therefore, (c)(4) would read as follows: "management of a rental property with more than four residential units". Second, (c)(7) should be deleted. This section should not apply to derivative and option investments.

CONCLUSION: Section 16308 of the California Act should be repealed and Section 403 of the 1997 Act should be adopted in its place, subject to the changes referenced above to Section 403(c).

PART 2 RECEIPTS NOT NORMALLY APPORTIONED

SECTION 412. OBLIGATION TO PAY MONEY

Section 16307 of the California Act works well. The corresponding section in the 1997 Act, Section 412, is acceptable as well. Under these circumstances, there is no compelling reason to change the present language, although we do not oppose the language of Section 412.

CONCLUSION: Section 16307 of the California Act should remain in its present form. None of the language of Section 412 should be adopted in California.

PART 3 RECEIPTS NORMALLY APPORTIONED

SECTION 421. DEFERRED COMPENSATION, ANNUITIES, AND SIMILAR PAYMENTS

Sections 16309 and 16310 of the California Act pertain to the allocation of receipts from natural resources and other assets which are subject to depletion. Generally, these sections give the trustee broad discretion to allocate the receipts, with income being favored.

Sections 421 - 424 of the 1997 Act are the corresponding sections. Section 421, pertaining to deferred compensation, annuities and similar payments, is complicated. The discretion given to the trustee on this subject under Section 16310 may be preferable. Likewise, the discretion given to the trustee under Section 16310 may be preferable to Sections 422, 423 and 424.

CONCLUSION: The sections of the California Act should remain in their present form unless there is a compelling reason for a change under Sections 421, 422, 423 or 424.

SECTION 422. LIQUIDATING ASSET

Sections 16309 and 16310 of the California Act pertain to the allocation of receipts from natural resources and other assets which are subject to depletion. Generally, these sections give the trustee broad discretion to allocate the receipts, with income being favored.

Sections 421 - 424 of the 1997 Act are the corresponding sections. Section 421, pertaining to deferred compensation, annuities and similar payments, is complicated. The discretion given to the trustee on this subject under Section 16310 may be preferable. Likewise, the discretion given to the trustee under Section 16310 is preferable to Sections 422, 423 and 424. It appears that the 1997 Act favors principal over income in this area.

CONCLUSION: The sections of the California Act should remain in their present form unless there is a compelling reason for a change under Sections 421, 422, 423 or 424.

SECTION 423. MINERALS, WATER, AND OTHER NATURAL RESOURCES

Sections 16309 and 16310 of the California Act pertain to the allocation of receipts from natural resources and other assets which are subject to depletion. Generally, these sections give the trustee broad discretion to allocate the receipts, with income being favored.

Sections 421 - 424 of the 1997 Act are the corresponding sections. Section 421, pertaining to deferred compensation, annuities and similar payments, is complicated. The discretion given to the trustee on this subject under Section 16310 may be preferable. Likewise, the discretion given to the trustee under Section 16310 is preferable to Sections 422, 423 and 424. It appears that the 1997 Act favors principal over income in this area.

CONCLUSION: The sections of the California Act should remain in their present form unless there is a compelling reason for a change under Sections 421, 422, 423 or 424.

SECTION 424. TIMBER

Sections 16309 and 16310 of the California Act pertain to the allocation of receipts from natural resources and other assets which are subject to depletion. Generally, these sections give the trustee broad discretion to allocate the receipts, with income being favored.

Sections 421 - 424 of the 1997 Act are the corresponding sections. Section 421, pertaining to deferred compensation, annuities and similar payments, is complicated. The discretion given to the trustee on this subject under Section 16310 is preferable. Likewise, the discretion given to the trustee under Section 16310 may be preferable to Sections 422, 423 and 424. It appears that the 1997 Act favors principal over income in this area.

CONCLUSION: The sections of the California Act should remain in their present form unless there is a compelling reason for a change under Sections 421, 422, 423 or 424.

SECTION 425. PROPERTY NOT PRODUCTIVE OF INCOME

The concept of underproductive property has been omitted from the 1997 Act. We generally concur with the omission although further consideration may need to be given to retaining certain portions of the Probate Code Section 16311.

Under the portfolio theory of investment, as prescribed by the prudent investor rule under Probate Code Section 16047(a), a trustee's investment and management decisions respecting individual assets and courses of action are evaluated not in isolation, but in the context of the trust portfolio as a whole and as part of an overall investment strategy having risk and return objectives reasonably suited to the trust. The concept of underproductive property was developed during a time when assets were evaluated in isolation and is therefore inconsistent with current theory. If a trust includes underproductive property, the detriment to the income beneficiary arising from the lack of income from the underproductive property can be offset by structuring other parts of the portfolio toward income producing assets.

SECTION 426. DERIVATIVES AND OPTIONS

The language of Probate Code Section 16315 should remain the same.

With respect to possible supplements to the California Act derived from the 1997 Act, we support the adoption of Section 426 of the 1997 Act, pertaining to derivatives and options, provided that (i) reference to Section 403 under Section 426(b) is omitted and

(ii) the words "an amount", which occur in two places in the first sentence of Section 426(c), are changed to "the amount".

SECTION 427. ASSET-BACKED SECURITIES

Section 427 of the 1997 Act, which relates to asset-backed securities, should be adopted.

ARTICLE 5. ALLOCATION OF DISBURSEMENTS DURING ADMINISTRATION OF TRUST

SECTION 501. DISBURSEMENTS FROM INCOME
SECTION 502. DISBURSEMENTS FROM PRINCIPAL

Probate Code Section 16312 deals with charges against income and principal. The corresponding sections of the 1997 Act are Sections 501 and 502.

The language of the California Act is more specific and of greater assistance with respect to the allocation of expenses. Therefore, we support retention of the current language. However, we propose that Section 16312 be amended to address the following issues:

1. The second sentence of Section 411 of the Act, relating to rental security deposits, should be incorporated into Section 16312(b).

2. The concepts of Section 413 of the Act (insurance proceeds) should be incorporated into Section 16312.

3. The concept of Section 502(a)(7) should be incorporated into Section 16312(b) so that it provides disbursements related to environmental matters are allocable to principal.

4. There should be a provision addressing how interest owing on taxes is to be allocated, which provision would need to be coordinated with the California proration tax statutes (Probate Code Sections 20100, et seq.). For a discussion of this issue see the October 1977 edition of the CEB Estate Planning and California Probate Reporter, Tax Apportionment, pages 58 - 60.

5. Although the current language is clear that a trustee's regular compensation must be allocated 50%-50% between income and principal, unless a court order is obtained that authorizes a different allocation, it is not clear how a trustee's extraordinary fees should be allocated. Certain provisions suggest that a trustee's extraordinary fees that primarily relate to the income interest are chargeable entirely to income, and that a trustee's extraordinary fees that primarily relate to the principal are chargeable entirely to principal. However, the

precise application is unclear because of the ambiguous language of the statute. The issue of the allocation of a trustee's extraordinary fees should be clarified.

CONCLUSION: Section 16312 of the California Act should remain in its present form, subject to the amendments discussed above.

SECTION 503. TRANSFERS FROM INCOME TO PRINCIPAL FOR DEPRECIATION

Probate Code Section 16313 gives the trustee the discretion to establish depreciation or depletion reserves. The corresponding sections of the 1997 Act are Sections 503 and 504.

Although the language of Sections 503 and 504 is not objectionable, there is no compelling reason to change the present language. However, it would be helpful to clarify whether the trustee is absolutely protected from liability if it does not establish a reserve, or whether the trustee's discretion is subject to a "reasonable" standard (see Probate Code Sections 16080 and 16202).

CONCLUSION: Section 16313 of the California Act should remain in its present form, subject to the clarification noted above. None of the language of Sections 503 and 504 of the 1997 Act should be adopted in California.

SECTION 504. TRANSFERS FROM INCOME TO REIMBURSE PRINCIPAL

Probate Code Section 16313 This Section gives the trustee the discretion to establish depreciation or depletion reserves. The corresponding sections of the 1997 Act are Sections 503 and 504.

Although the language of Sections 503 and 504 is not objectionable, there is no compelling reason to change the present language. However, it would be helpful to clarify whether the trustee is absolutely protected from liability if it does not establish a reserve, or whether the trustee's discretion is subject to a "reasonable" standard (see Probate Code Sections 16080 and 16202).

CONCLUSION: Section 16313 of the California Act should remain in its present form, subject to the clarification noted above. None of the language of Sections 503 and 504 of the 1997 Act should be adopted in California.

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February 9, 1998

Law Revision Commission
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File:___________

Mr. Nathaniel Sterling
Executive Secretary
California Law Revision Commission
4000 Middlefield Road, Room D-1
Palo Alto, CA 94303-4739

Dear ~~Nathaniel~~ Nat:

Uniform Principal and Income Act
(1997)

As discussed over the weekend, I am enclosing a Discussion Draft Memorandum of the American Bankers Association for the NCCUSL Annual Conference in 1995 concerning a trustee's power to reallocate receipts and disbursements then contained in Article 6 of the Act but now found in Section 104 of the Act.

The main points for our opposition to Section 104 are as follows:

— No one affected by the proposal, neither beneficiaries or trustees, is agitating for a reallocation provision. In fact, almost every professional trustee trustee I am aware of is against the proposal (once they understand it).

— Section 104 would drive beneficiaries and trustees away from the safe-harbor or default provisions of the Act into a nebulous world where the trustee has discretion to determine the extent of the "income" beneficiaries' interests and those of the remainder men.

— The Act gives no standards for the trustee to follow in exercising discretion. The standards in Section 104(b) are vague, non-specific and of no help to trustees, and could justify a variety of outcomes regarding similar fact situations and among a variety of trustees.

— Because of the vagueness or non-specificity of Section 104, it opens up the possibility of continuing arguments and litigation between beneficiaries and trustees about the extent of a beneficial interest. What was formerly a routine and fairly well-understood part of trust administration could now become a new battleground among beneficiaries and between beneficiaries and trustees.

— It will increase the costs, delays and complexities of administering trusts, a result that is in no one's best interest.

— There are other, far better understood, methods of increasing the amount of funds going to an income beneficiary if the beneficiary requires more money than produced by the trustee's investment philosophy. Most trust instruments contain discretionary powers in the trustee permitting invasion of principal for the benefit of the income beneficiary in a proper case. This should eliminate one of the biggest supposed obstacles to a trustee who wishes to follow the modern portfolio method of investing.

If you have any questions or would like to discuss the enclosed materials further, please let me know and I will be happy to oblige.

Yours very truly,

Alex Misheff

Alexander P. Misheff

APM/gds
Enclosures (3)

June 27, 1995

DISCUSSION DRAFT MEMORANDUM
OF THE AMERICAN BANKERS ASSOCIATION'S TRUST COUNSEL COMMITTEE
TO THE NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS
CONCERNING THE TRUSTEE'S POWER TO REALLOCATE RECEIPTS AND DISBURSEMENTS BETWEEN INCOME AND PRINCIPAL CONTAINED IN ARTICLE 6 OF THE DRAFT OF THE UNIFORM PRINCIPAL AND INCOME ACT (199__)
PRESENTED TO THE CONFERENCE'S AUGUST 3-4, 1995 MEETING

I. Introduction

The American Bankers Association welcomes the opportunity to comment on the power provided trustees in Section 601 of the current Draft of the Uniform Principal and Income Act (199__) to reallocate receipts and disbursements between income and principal. Subsection (a) of Section 601 states:

> "(a) If after applying the foregoing provisions of this [Act], the trustee determines that to comply with Section 102(a) it is necessary to reallocate between income and principal, the trustee may reallocate in whole or in part in such manner and in such proportions as the trustee determines."

Some but not all of the impetus for this provision was generated by the changes in investment strategy for trust accounts exemplified in the Uniform Prudent Investor Act.

An acknowledged primary source for the Uniform Prudent Investor Act is the Prudent Investor Rule promulgated in the Restatement Third, Trusts (Prudent Investor Rule) by the American Law Institute. Section 181 of Restatement Third provides that a trustee is normally under a duty to manage trust property so that the trust can reasonably be expected to produce a total return that is consistent with the objectives of caution and impartiality as appropriate to the particular trust. Total return is recognized as including not only income productivity, but also return to principal with these competing interests balanced in a way that is appropriate to the particular trust.

As the Comment to the proposed §601 of the Uniform Principal and Income Act indicates, the purpose of the proposed reallocation provision is to alleviate a perceived tension between modern rules for trust investment and traditional ideas about what constitutes the return on a portfolio. It was thought desirable that a trustee should be able to make the most prudent and productive trust investments without concern as to whether the investments chosen would affect the allocation of that return between income and principal beneficiaries. Achieving an investment return and allocating it are related, but separate, ideas and processes.

However, §601(a) itself clearly recognizes that the starting point in the determination of principal and income remains the traditional allocation system contained in Articles 1-5 and 7 of the Uniform Principal and Income Act. It is only after the traditional principal and income allocation rules are applied and the trustee makes a conscious decision that a reallocation is necessary to achieve impartiality that the power to make a reallocation arises.

The Comment to §601 further states that trustees will have the power under the section to deal with extraordinary and unanticipated situations and to overrule unjust results under the standard provisions of the Act. There is nothing in §601, however, that would assist a trustee in making a determination that a result reached under the traditional provisions of the Act might be unjust. Since the trustee's power of reallocation arises out of a perceived need to achieve impartiality between the income beneficiary and the remainder beneficiary, perhaps by implication an unjust result under the traditional provisions of the Act is one that is not impartial. Section 601 is far from clear on the matter.

We would also note that §227, Comment i of Restatement Third recognizes the difficulty of satisfying the concerns of successive beneficiaries which are "to a certain extent antagonistic."

Finally, according to a report entitled "*Trust Assets of Financial Institutions -- 1993*", published by the Federal Financial Institutions Examination Council, Washington, D.C., Table A-2, 2996 financial institutions regulated by various federal agencies had discretionary assets of $556,091,176,000 held in 875,737 discretionary personal trust accounts on December 31, 1993, the latest information available. The American Bankers

Association does not purport to speak for all of these institutions but does do so for more than 90% of American banks. There is also an unknown number of discretionary personal trust accounts of which individuals are trustees. It would not be unreasonable to say that at least as many trusts are administered by individual trustees as by financial institutions. The point to be kept in mind is that the rule as to reallocation, if it were adopted by all 50 states, would govern the activities of between one and one-half and two million trusts. Section 706 applies the whole Act to all existing trusts and estates, but only as to receipts and expenses received or incurred after the effective date of the Act. This is a substantial impact and any major change of past practice for trustees should consider its effect not only on professional trustees but on non-professional trustees as well. A rule of this sort should be clear enough for even a first time trustee to administer without inadvertently incurring liability. It should also be clear enough for income beneficiaries to understand so that they can predict within reason potential reallocations to or from income before incurring financial obligations to be paid for from their trust income. Finally, it should really be necessary, i.e., there shouldn't be a better way to reach the same result, which is for the trustee to allocate investment return among the various beneficiaries as the settlor intended.

The drafting committee of the Uniform Principal and Income Act has certainly established a laudable goal of seeking to assure "impartiality" for beneficiaries. Whether it has been successful in achieving the goal is less certain.

The comments that follow are divided essentially into two sorts: first, comments about the concept of reallocation, and second, comments about the practicability of the proposed version of reallocation in §601.

II. Comments on the Concept of Reallocation.

There is no satisfactory definition of "impartiality". Reallocation is deemed necessary, if at all, to achieve "impartiality". Section 102(a) states that an account is governed "impartially" if it is administered first in accordance with the provisions of the governing instrument, next if there is no governing instrument provision, by the good faith exercise of a discretionary power given the fiduciary by the governing instrument, thirdly, in the absence of both of these, in accordance with the provisions of the Act, and finally if none of these apply in accordance with what is "fair and reasonable" to all of the beneficiaries. Subsection (b) adds that if a fiduciary is in doubt about what is "fair and reasonable" in a particular situation the fiduciary "shall resolve the doubt by adding the receipt or charging the expense to principal." Thus, "impartiality" in this context (i.e., with no applicable document or other Act provisions) usually means what is "fair and reasonable". A dictionary synonym of "fair" is "impartial". (Webster's Third New International Dictionary). The definition is therefore essentially circular. Also, as mentioned in Restatement Third, §227, Comment i, just as "...the purposes, specific terms, and general circumstances of trusts often fail to offer the guidance trustees might wish for in establishing suitable investment objectives and strategies..." so also they fail to offer the guidance trustees might wish for in determining what is fair and reasonable. The central problem with §601 is that it gives the trustee very broad new powers to reallocate without any meaningful standard to follow. It opens the trustee to all kinds of reallocation proposals offered by competing beneficiaries. Every reallocation or failure to reallocate may be open to question. If a power to reallocate is necessary at all, would it not be preferable to add a more specific definition to §601, such as "all other circumstances being equal, 'impartiality' means striving for an even division of the total investment return over the expected relevant time horizon between income beneficiaries and remainder beneficiaries." Other possible standards might reference historical rate of returns and/or the Consumer Price Index. The other way to determine the meaning of "impartiality" is through litigation, which will serve neither trustees nor beneficiaries well.

The reallocation proposal contains misleading analogies to quite different situations. For instance, examples 5 and 6 in the Comment to §601, which are the only ones which explicitly approve the use of the power to reallocate as to a whole portfolio, make reference to rates of endowment return and spending by universities and colleges. There are at least three critical distinctions between university endowments and most personal trusts. First, university endowments are tax exempt and personal trusts (other than charitable trusts) are not. Therefore selling capital assets at a gain in an university endowment fund will not generate tax costs whereas it will do so in a personal trust. The cost of investing, including taxes, is of course a primary consideration under the

Prudent Investor Rule for all trustees (Uniform Prudent Investor Act 2(c)(3))[1]. The trustee who is investing for "total return" in a personal trust without consideration of this important factor would presumably be guilty of breach of trust. However, neither §601 nor the examples in the Comment deal with the income tax burden that may be generated by reallocation decisions and how it would affect income beneficiaries and principal remaindermen of personal trusts.

Second, the managers of university endowments are legally answerable only to one set of interests, the university administration. The trustee of every personal trust, however, must decide between two sets of interests, income and remainder beneficiaries, which, as mentioned earlier in the quotation from Restatement Third, Trusts, "are to a certain extent antagonistic". In most personal trusts any reallocation between principal and income will take money from one interest and give it to another interest. Trustees of course are required to make decisions between conflicting interests all the time, but, unlike university endowment fund managers, if they make the wrong decision as to reallocation they do so at the risk of legal liability.

Third, university spending rates may have nothing to do with the needs of human beings who constitute the vast bulk of trust beneficiaries. Any analogy should be to some standard more relevant to the actual beneficiaries , such as the Consumer Price Index.

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1 See also comment to section 2, of the Uniform Prudent Investor Act, p. 8. "Under the present recognition rules of the federal income tax, taxable investors, including trust beneficiaries, are in general best served by an investment strategy that minimizes the taxation incident to portfolio turnover."

The application of the power to reallocate as presented is too broad. It is too broad in that, as stated at page 57 of the current Draft:

"This section is a default rule of trust law."

Also, subsection 601(d) provides that even explicit language limiting the power of a trustee to make equitable adjustments will not be construed to be contrary to this section unless it is clear from the context that it is intended to deny the trustee "access to a power of reallocation". The only avowed purposes for creating a power to reallocate are to implement modern rules of investing and to deal with "extraordinary and unanticipated situations" as mentioned in the New Jersey and Connecticut statutes referred to in the third paragraph of the Comment to §601. The great majority of American trustees are probably not now using Prudent Investor concepts and it may be a number of years before the Uniform Prudent Investor Act is widely adopted. Why should a trustee be forced to follow a rule to reallocate designed to implement a style of investing which he (or a settlor) has not chosen to follow? If any reallocation rule should be adopted, it should be limited to trustees using the Prudent Investor Rule and/or for "extraordinary and unanticipated situations."

Applying this rule to future receipts and expenses may even have the effect of frustrating the grantor's intent. Consider the not unusual situation of a trust invested in large part in a low-dividend-paying family business. Reallocating and distributing more of the total return of the investment to an income beneficiary may be "fair" to the income beneficiary, but may also require the trustee to sell shares of the company or distribute them to the income beneficiary, diffusing control the grantor wanted to remain in the trust. The same problem can arise concerning real estate. There may be other problems with such assets. By definition, there is no market for illiquid assets. There may be SEC restrictions with some stock. There could be huge capital gains tax problems that would wipe out any benefit to income beneficiaries. The concept is totally unworkable for closely held businesses, real estate, oil and gas, IRA benefits, insurance, options, deferred compensation, and derivatives.

<u>There are so many situations in which the power to reallocate will not or may not apply that one wonders whether it should be the general rule.</u> Leaving aside problems created by the type of trust asset, there are many trusts which by the nature of their other provisions will not need a power to reallocate. Presumably any trust in which the trustee has the power to pay income and/or principal and to accumulate income on a discretionary basis already contains a mechanism to shift economic interests in trusts, so the power to reallocate under §601 will be unnecessary as to them.

It may also be questioned whether this power can be used in trusts purporting to qualify for the marital deduction under the federal estate tax laws. As discussed later in this memorandum, the Internal Revenue Service might have serious concerns about a trustee's ability to reallocate and its impact on a surviving spouse's beneficial enjoyment of income (a precondition for obtaining the marital deduction), so that the power to reallocate may not be applicable to such trusts.

Nor is the power to reallocate necessary for split interest charitable trusts and private foundations where distributions can be funded from either income or principal. The Uniform Prudent Investor Act doesn't apply to estates and guardianships, and apparently neither does Article 6 of the Uniform Principal and Income Act, which refers exclusively to "trustees". Trustees can already reallocate receipts and disbursements in revocable trusts without affecting any one's interest except that of the grantor. Finally, investment diversification principles would usually mandate some balance between stocks and bonds, producing traditional income and capital appreciation, and, therefore, some inherent balance between income and principal return.

There would therefore seem to be enough exceptions or limitations to the general rule of reallocation to raise a doubt as to whether it should be the general rule or the exception to a contrary general rule. Reallocation would seem to apply only to irrevocable noncharitable, non-marital trusts required to distribute net trust accounting income with no principal invasion clause, or, essentially, "simple" trusts for trust income tax purposes.

<u>There are other ways to achieve the same result.</u> We believe it could be argued that all of Article 6 could be rendered unnecessary by §102(a)(4), discussed earlier under the

duty of impartiality, which states that if neither the instrument nor the Act covers a situation, the trustee may exercise his discretion to allocate "in accordance with what is fair and reasonable to all of the beneficiaries". Alternatively, perhaps the provision in §103, "Limitation on Fiduciary Liability", could be used to tailor a result to the facts and circumstances of each particular situation. The trustee would reach agreement with the income beneficiaries and presumptive remaindermen as to the allocation of receipts. The fourth paragraph of page 57 of the current Draft cites these Sections explicitly but does not seem to draw the conclusion we have drawn from them:

> This section is subject to the injunctions in Section 102 of this Act including the one that the trustee "shall be fair and reasonable to all of the beneficiaries unless the governing instrument clearly manifests and intention that the fiduciary must or may favor one or more beneficiaries." This section is also subject to the limitations on fiduciary liability in Section 103.

Why do not Sections 102 and/or 103 by themselves provide a sufficient mechanism to deal with reallocation questions?

<u>Settlors should make a conscious decision to require their trustees to reallocate.</u>

There is a curious twist of logic in the comment entitled "Default Rule". The fifth paragraph of the Comment on page 57 reads:

> This section is a default rule of trust law. A settlor can expressly set aside this rule, just as a settlor can establish a noncharitable unitrust, instead of a traditional trust, to avoid some of the problems that arise when a trustee invests in a modern fashion within a traditional trust.

If a settlor wants to "avoid some of the problems that arise when a trustee invests in a modern fashion within a traditional trust", why shouldn't he be required to affirmatively elect to have a power of reallocation contained in the document just as he is required to affirmatively elect to establish a noncharitable unitrust? Such a requirement would force all prospective settlors to decide the issue of reallocation explicitly so that trustees will not have to guess at their peril what settlors intended. If nobody knows what settlors would have thought about reallocation, it shouldn't be a default rule. Or maybe the rule as to reallocation should apply only to instruments executed after the effective date of the Act, so that grantors will at least have an opportunity to consider reallocation and by their silence opt in to it.

The decision to use a new investment strategy (total return) is logically distinct from the decision of who should receive the economic benefits of the return. Settlors presented with the alternative of "total return" and reallocation might well also change their dispositive provisions from, for instance, a net income trust to a discretionary trust, to prevent a greater than expected amount of money being placed in the hands of an income beneficiary.

III. Practicability of the Proposed Version of Reallocation in §601

There is no indication of how frequently a trustee should review a trust to determine whether it is necessary to reallocate.

This is not quite so simple a point as it seems. There is usually a mismatch of timing between distributions to income beneficiaries on the one hand and remaindermen on the other hand. If, as examples 3 and 4 of the Comment to §601 suggest, amounts which have traditionally been considered income, such as interest and dividends, are transferred from income to principal, then this may not in theory be a problem (although the response of many income beneficiaries when they are told that, as pointed out in examples 3 and 4, some of "their" bond interest is being withheld to be added to principal may be an angry one).

The situation the examples do not consider is one when at one point during the administration of the trust there is a large amount of appreciation in principal, some of which is reallocated to income and given to income beneficiaries, and then upon termination of the trust the remaining principal value has been greatly reduced through market action. The income beneficiary may thus have received more than his "fair" share of the trust's total return. Perhaps an "allocation reserve" should be established to hold proposed reallocations to income until the termination of an interest when the net realized appreciation and the net income distributions can be compared and the difference, if any, reallocated, considering at that point the time value of money for previous distributions. Reallocating only at that point however hardly seems worth the effort if the principal return exceeds the income return (because the income beneficiary would often be dead and reallocation would be paid to an income beneficiary's estate). It would also be perhaps not much different than the power found in §426 of the Act to reallocate for unproductive property. If the income return has exceeded the principal return, it would be virtually impossible, not to say expensive and embarrassing, to ask income beneficiaries to return monies that had already been distributed to them to reallocate to remainder beneficiaries.

If a one-time reallocation is not acceptable, then it would seem to be necessary, although not discussed by the draftsmen of §601, for each trustee to review each of his accounts periodically (perhaps annually in connection with a regular investment review) to determine whether a reallocation is necessary, even if no reallocation ultimately is made. It might even be necessary to reallocate every time there is an income distribution. This will add to the expense and work of thousands of trustees.

There are a number of practical tax problems with this suggested draft. Section 601(c) prevents a trustee from using this power so as to jeopardize any federal or state gift, estate, income or inheritance tax deduction or exclusion. The last sentence on page 56 of the Comment to §601 adds "It is hoped the marital deduction will be available under this section of the Act." Example 4 of the Comment to §601 permits income to be accumulated by the trustee. Treas. Reg. 20.2056(b)-5(f) deals with the situation where the surviving spouse is deprived of "the substantial enjoyment (of the income) during her (sic) life required by the (Internal Revenue Code)" for purposes of obtaining the marital deduction. Treas. Reg. 20.2056(b)-5(f)(7) states:

> "An interest passing in trust fails to satisfy (the income requirement) to the extent that the income ... may be accumulated in the discretion of any person other than the surviving spouse."

On its face, §601 seems to be in direct conflict with this regulation. The draftsmen should try to articulate what interest the Congress was trying to protect in requiring an income interest for the surviving spouse in order to obtain a marital deduction and why §601 protects that interest.

Also, the fifth paragraph of page 56 of the Comment to §601 states that any capital gains realized to fund a reallocation payment to the income beneficiary shall be allocated to the income beneficiary. However, nothing is said about shifting the burden of the capital gains tax that may be incurred on a reallocation. Normally, in a non-grantor personal trust, realized capital gains are not included in distributable net income and taxed out to the income beneficiaries. Instead, they are taxed in the trust at the trust's applicable income tax rate. There is an exception where under either the terms of the trust instrument or applicable state law capital gains are allocated to the income beneficiaries.

We feel there is a serious question whether a reallocation of a capital gain to income under §601 is the kind of circumstance that the IRS would consider as an exception to the normal DNI rules. The existing IRS Regulations do not deal with a reallocation power in a trustee similar to the one contemplated in §601. The result is that there is a major uncertainty whether the capital gains tax on a reallocation remains in the trust or whether it falls on the income beneficiaries. If the capital gains tax remains a trust liability, it would be charged against the principal remaindermen of the trust who would receive none of the benefits of the reallocation. Such a result would be manifestly unfair to the remaindermen and would fly in the face of the impartiality rationale of §601.

If on the other hand, the capital gains tax can properly be taxed to the income beneficiaries, this adds new layers of complexity for trust accounting purposes. Let's say two assets are sold, one at a gain to reallocate to the income beneficiary, and another, later, at a loss for purely investment purposes. There is still a gain, but a smaller one. If the tax on the net gain is allocated to income, it could be unfair to the remaindermen, who could use a principal loss carryover to offset other gain generated purely for investment reasons. Secondly, the difference in tax brackets between the trust and the income beneficiaries to whom the proceeds may be distributed should be considered. If the income tax attributable to amounts to be reallocated and distributed to income beneficiaries is also assessed against them at the trust's rate, it may make it too cumbersome and expensive even to consider a reallocation.

More generally, the draftsmen should work through carefully the trust income tax implications of reallocation. Would principal return reallocated to the income beneficiaries be "distributable net income" and qualify for a distribution deduction under IRC §661? In deciding to accumulate income, what weight should a trustee give to the fact that the trust has a higher marginal tax rate than the income beneficiaries?

We would also point out that if the trustee's power to reallocate should be viewed as a discretionary power to reallocate between principal and income, the IRS might well conclude that such power would be deemed a general power of appointment for income and estate tax purposes, if held by certain people. This may produce some unforeseen and adverse income tax consequences. For example, if the grantor of an otherwise non-grantor trust is also the trustee, the trust may be treated as a grantor trust.

We therefore suggest that it would be highly advisable to seek a definitive statement from the IRS as to whether §601 jeopardizes the marital deduction, on the question of liability for capital gains tax incurred on a reallocation, and on whether the trustee's power to reallocate would be viewed as a general power of appointment before proceeding much further with proposed §601.

Proposed Section 601 will add to the work and expense of trustees, and, ultimately, probably add to the cost of providing trust services. The current system of allocating dividends and interest to income and capital gains to principal has the advantage that it can be done through automated trust accounting systems. Interest and dividends can be coded to be allocated to income and gains on sale to principal. These mechanical systems would of course stay in place if the power of reallocation were to be superimposed upon the trust structure, but the power of reallocation is an additional manual step to be taken before distributions can be made to income beneficiaries. As suggested earlier, if all trustees must consider whether to reallocate as to each of their trusts for future receipts and disbursements, prudent trustees to protect themselves presumably would review their accounts periodically, perhaps every year or even perhaps with every income distribution, to determine whether a reallocation was necessary. They would also need to establish some benchmarks to help them determine what is "fair and reasonable". Perhaps such a general rule could require that the net appreciation (or net depreciation?) and net income since the last distribution be computed and divided by two and one-half distributed to the current income beneficiary and one-half to principal. Or perhaps the distribution going to income beneficiaries could be based on the Consumer Price Index and the balance be allocated to principal. Alternatively perhaps the distribution could be based on historical rates of return. In any event it will require a new set of record keeping for each account over the term of the account and presumably in the case of a bank a review by a senior committee of the corporate trustee to insure reallocation was "fair and reasonable".

No conclusive effect or other protection is offered the trustee by §601 in deciding whether or not to reallocate. Other than the mechanism in §103 limiting fiduciary liability, there is nothing stating that a good faith attempt by the trustee to reallocate "fairly" is immune from judicial attack.

IV. Conclusion

The American Bankers Association has for many years favored progressive measures as to trust investment. As the comment to section one of the Uniform Prudent Investor Act notes, the American Bankers Association sponsored the Model Prudent Man Rule Statute in 1942 to modernize trust investments. We also participated more informally in the formulation of the Uniform Prudent Investor Act. Reallocating investment return is a different question. Perhaps some reallocation may be necessary in some trusts under the Uniform Prudent Investor Act or similar legislation. However, for the reasons indicated we are opposed to Article 6. We feel to the extent reallocation is necessary, this reallocation could better be implemented by further refining the "fair and reasonable" concept in §102(a)(4) than by the overbroad and cumbersome provisions of Article 6. Such refinements should give the trustee an objectively determinable "safe harbor" definition for "impartiality" as a starting point, and deal more thoughtfully with what kind of trusts the power to reallocate should apply to (perhaps grantors should be required to "opt in" to such a system), how often reallocation should occur, how taxes impact reallocation decisions and how all trustees can be protected from litigation on these questions.

An even better prospective solution than reallocation from a trustee's point of view is for estate planners to be better educated about "total return" investment concepts and for them to make increased use of discretionary clauses distributing income and principal in drafting trusts. Trust investment decisions, and decisions to allocate investment returns, shouldn't exist in the abstract, but in relation to the particular needs of particular people. Discretionary dispositive clauses address the real issue of who should get the investment return and render the power to reallocate superfluous.

(ABA\COMMENTS.DOC)

Existing Law, with Commission Comments

CHAPTER 3. REVISED UNIFORM PRINCIPAL AND INCOME ACT

§ 16300. Short title

16300. This chapter may be cited as the Revised Uniform Principal and Income Act.

Comment (1990). Section 16300 continues Section 16300 of the repealed Probate Code without change.

Background on Section 16300 of Repealed Code

Section 16300 was added by 1986 Cal. Stat. ch. 820 § 40. The section continued former Civil Code Section 730 (repealed by 1986 Cal. Stat. ch. 820 § 2) without change. For background on the provisions of this division, see the Comment to this division under the division heading.

§ 16301. Definitions

16301. As used in this chapter:

(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) "Remainder beneficiary" means the person entitled to principal, presently or in the future, including income which has been accumulated and added to principal.

Comment (1990). Section 16301 continues Section 16301 of the repealed Probate Code without change. See also Section 84 ("trustee" defined).

Background on Section 16301 of Repealed Code

Section 16301 was added by 1986 Cal.Stat. ch. 820 § 40. Subdivisions (a) and (b) continued subdivisions (1) and (2) of former Civil Code Section 730.01 (repealed by 1986 Cal.Stat. ch. 820 § 2) without change. Subdivision (c) restated subdivision (3) of former Civil Code Section 730.01 (which defined "remainderman") without substantive change and with the addition of the language "presently or in the future." For background on the provisions of this division, see the Comment to this division under the division heading.

§ 16302. Receipts and expenditures

16302. (a) A trust shall be administered with due regard to the respective interests of income beneficiaries and remainder beneficiaries. 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 chapter.

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

(3) If neither paragraph (1) nor (2) is applicable, in accordance with the standard of care provided in Section 16040 and with what is reasonable and equitable in view of the interests of those entitled to income as well as of those entitled to principal.

(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 that the trustee has improperly exercised such discretion arises from the fact that the trustee has made an allocation contrary to a provision of this chapter.

Comment (1990). Section 16302 continues Section 16302 of the repealed Probate Code without change. Subdivision (b) substitutes a reference to improper exercise of discretion for the reference in Section 2 of the Revised Uniform Principal and Income Act (1962) to "imprudence or partiality." This variation of the language of the Uniform Act was drawn from Nebraska Law. Neb.Rev.Stat. § 30-3102 (1985). The result of this change is that there is no inference of any sort of impropriety, not just imprudence or partiality, arising from an allocation contrary to this chapter.

Background on Section 16302 of Repealed Code

Section 16302 was added by 1986 Cal.Stat. ch. 820 § 40. The section continued former Civil Code Section 730.02 (repealed by 1986 Cal.Stat. ch. 820 § 2) with two changes: Subdivision (a)(3) adopted the revised general standard of care provided in Section 16040 in place of the former reference to ordinary prudence, discretion, and judgment. Subdivision (b) replaced the former reference to "imprudence or partiality" with a reference to improper exercise of discretion. For background on the provisions of this division, see the Comment to this division under the division heading.

§ 16303. Income; principal

16303. (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 prepayment of principal except as provided in Section 16307 on bond premium and bond discount.

(3) Receipts allocated to income as provided in Section 16304.

(4) Income earned during administration of a decedent's estate as provided in Section 16305.

(5) Corporate distributions as provided in Section 16306.

(6) Accrued increment on bonds or other obligations issued at discount as provided in Section 16307.

(7) Receipts from business and farming operations as provided in Section 16308.

(8) Receipts from disposition of natural resources as provided in Section 16309.

(9) Receipts from other principal subject to depletion as provided in Section 16310.

(10) Receipts from disposition of underproductive property as provided in Section 16311.

(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 remainder beneficiary 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) Receipts allocated to principal as provided in Section 16304.

(5) Stock dividends, receipts on liquidation of a corporation, and other corporate distributions as provided in Section 16306.

(6) Proceeds from the disposition of bonds and other obligations for the payment of money as provided in Section 16307.

(7) Royalties and other receipts from disposition of natural resources as provided in Section 16309.

(8) Receipts from other principal subject to depletion as provided in Section 16310.

(9) Any profit resulting from any change in the form of principal except as provided in Section 16311 on underproductive property.

(10) Receipts from disposition of underproductive property as provided in Section 16311.

(11) Any allowances for depreciation established under Section 16308 and paragraph (2) of subdivision (b) of Section 16312.

Comment (1990). Section 16303 continues Section 16303 of the repealed Probate Code without change.

Background on Section 16303 of Repealed Code

Section 16303 was added by 1986 Cal.Stat. ch. 820 § 40 and amended by 1987 Cal.Stat. ch. 128 § 17. The section restated subdivisions (a) and (b) of former Civil Code Section 730.03 (repealed by 1986 Cal.Stat. ch. 820 § 2) without substantive change. Subdivisions (a)(3) and (b)(4) were new cross-references, but represented no substantive change. Subdivision (a)(6) corrected a defect in former law. For background on the provisions of this division, see the Comment to this division under the division heading.

§ 16304. Right to income; apportionment

16304. (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 item of property becomes subject to the trust. In the case of an item of property becoming subject to a trust by reason of a person's death, it becomes subject to the trust as of the date of the death of the person even though there is an intervening period of administration of the person's estate, except that income on the property during the period of administration is governed by Chapter 8 (commencing with Section 12000) of Part 10 of Division 7, and becomes subject to the trust as it accrues.

(b) Upon property becoming subject to a trust by reason of a person's death:

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

(2) Receipts in the form of periodic payments (other than corporate distributions to stockholders), including rent, interest, or annuities, not due at the date of the death of the person 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 income-producing property is income even though the receipt was earned or accrued in whole or in part before the date when the property became subject to the trust.

(d) If an income beneficiary's right to income terminates by death or in any other manner, income paid to the income beneficiary or received by the trustee before the termination belongs to the income beneficiary or his or her personal representative. All income 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 is subject to subdivision (d) of Section 21524 and does not apply to income received by a trustee under subdivision (b) of Section 16305.

(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.

(f) A distribution to a beneficiary of current income is payable not less frequently than annually.

Comment (1990). Section 16304 continues Section 16304 of the repealed Probate Code without change. For accrual of interest on unpaid distributions of current income, see Section 16314 (interest on trust distributions). As to the applicability of the 1988 changes made in Section 16304 to a trust created before July 1, 1989, see Section 16315. As to the application of any amendments made after that date, see Section 3.

Background on Section 16304 of Repealed Code

Section 16304 was added by 1986 Cal.Stat. ch. 820 § 40 and was amended by 1987 Cal.Stat. ch. 923 § 100 and by 1988 Cal.Stat. ch. 1199 § 106. The section continued former Civil Code Section 730.04 (repealed by 1986 Cal.Stat. ch. 820 § 2) without substantive change, except that subdivision (b)(2) was conformed to Section 4(b)(2) of the Revised Uniform Principal and Income Act (1962) and references to the testator and the will were replaced. As to the construction of provisions drawn from uniform acts, see Section 2. The first change--contrary to the former rule--required apportionment of rent, interest, and annuities. The effect of the last change was to make the principles of this section applicable to the problem of apportionment of income following the death of a settlor of a revocable living trust. The references to "assets" in former Civil Code Section 730.04 were replaced with references to "property"; these are non-substantive changes. See Section 62 ("property" defined). For background on the provisions of this division, see the Comment to this division under the division heading.

The 1987 amendment revised subdivision (d) to recognize a QTIP election under Section 21524(d). See Recommendation Relating to Marital Deduction Gifts, 19 Cal.L. Revision Comm'n Reports 615, 633-34 (1988).

The 1988 amendment revised subdivision (a) of Section 16304 to make clear that the rules governing accrual of income on testamentary distributions in trust during an intervening period of estate administration are the rules applicable to estate administration. The 1988 amendment also added subdivision (f) to fill in a gap in the law and made technical revisions in subdivision (d).

§ 16305. Income earned during administration of estate

16305. (a) Unless the will otherwise provides, income from the property 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 8 (commencing with Section 12000) of Part 10 of Division 7. Income received by a trustee under this subdivision shall be treated as income of the trust.

(b) If an income beneficiary's right to income, including interest payable under Section 12003, terminates by death or in any other manner during the period of probate administration, income attributable to the period of probate administration, 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.

Comment (1990). Section 16305 continues Section 16305 of the repealed Probate Code without change. As to the applicability of the 1988 changes made in Section 16305 to a trust created before July 1, 1989, see Section 16315. As to the application of any amendments made after that date, see Section 3.

Background on Section 16305 of Repealed Code

Section 16305 was added by 1986 Cal.Stat. ch. 820 § 40 and was amended by 1988 Cal.Stat. ch. 1199 § 106.5. Subdivision (a) continued subdivisions (a) and (b) of former Civil Code Section 730.05 (repealed by 1986 Cal.Stat. ch. 820 § 2) without change. The reference to “assets” in former Civil Code Section 730.05 was replaced with a reference to “property”; this was a non-substantive change. See Section 62 (“property” defined). Subdivision (b) continued former Civil Code Section 730.05(c) without change. For background on the provisions of this division, see the Comment to this division under the division heading.

The 1988 amendment to Section 16305 corrected a section reference in subdivision (a). The amendment also revised subdivision (b) to reflect the repeal of separate probate administration provisions relating to interest on the share of a trust beneficiary; these provisions were superseded by Sections 16304 (when right to income arises) and 16314 (interest on trust distributions).

§ 16306. Corporate distributions

16306. (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) In the case of a regulated investment company or a trust qualifying and electing to be taxed under federal law as a real estate investment trust:

(1) Distributions made from ordinary income are income.

(2) All other distributions, including distributions from capital gains, depreciation, or depletion, whether made in the form of cash, 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 chapter concerning the source or character of dividends or distributions of corporate assets.

Comment (1990). Section 16306 continues Section 16306 of the repealed Probate Code without change.

Background on Section 16306 of Repealed Code

Section 16306 was added by 1986 Cal.Stat. ch. 820 § 40. Subdivisions (a), (b), (d), and (e) continued subdivisions (a), (b), (d), and (e), respectively, of former Civil Code Section 730.06 (repealed by 1986 Cal.Stat. ch. 820 § 2) without change. Subdivision (c) restated former Civil Code Section 730.06(c) without substantive change. For background on the provisions of this division, see the Comment to this division under the division heading.

§ 16307. Bonds and other obligations

16307. (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.

Comment (1990). Section 16307 continues Section 16307 of the repealed Probate Code without change.

Background on Section 16307 of Repealed Code

Section 16307 was added by 1986 Cal.Stat. ch. 820 § 40. The section continued former Civil Code Section 730.07 (repealed by 1986 Cal.Stat. ch. 820 § 2) without change. For background on the provisions of this division, see the Comment to this division under the division heading.

§ 16308. Business and farming operations

16308. (a) If a trustee uses any part of the principal in the operation of a business, including an agricultural or farming operation, of which the settlor was a sole proprietor or a partner, the net profits and losses of the business shall be computed in accordance with recognized methods of accounting for a comparable business. Net profits from a business are income. Net losses from a business do not reduce other trust income for the fiscal or calendar year during which they occur but shall be carried into subsequent fiscal or calendar years and reduce the net profits of the business for those years.

(b) Subdivision (a) is subject to the provisions of Section 16313 and for this purpose any property of the business or agricultural or farming operation shall be deemed to be "trust property" within the meaning of Section 16313.

Comment (1990). Section 16308 continues Section 16308 of the repealed Probate Code without change. The last sentence of subdivision (a) is drawn from statutes in Nebraska and Wisconsin. Neb.Rev.Stat. § 30-3109 (1985); Wis.Stat.Ann. 701.20(8) (West 1981). The reference to "recognized methods of accounting" is drawn from the Nebraska statute. Neb.Rev.Stat. § 30-3109 (1985). This reference replaces the term of art "generally accepted accounting principles" which may be inappropriate as applied to certain types of businesses, such as agricultural and farming operations.

Background on Section 16308 of Repealed Code

Section 16308 was added by 1986 Cal.Stat. ch. 820 § 40. For background on the provisions of this division, see the Comment to this division under the division heading.

Section 16308 continued subdivisions (a) and (c) of former Civil Code Section 730.08 (repealed by 1986 Cal.Stat. ch. 820 § 2) without substantive change, except for two important changes:

(1) The last sentence of subdivision (a) reversed the former rule against carrying losses forward. This revision is drawn from statutes in Nebraska and Wisconsin. Neb.Rev.Stat. § 30-3109 (1985); Wis.Stat.Ann. 701.20(8) (West 1981).

(2) The reference in former law to "generally accepted accounting principles" was replaced with a reference to "recognized methods of accounting." This change avoids use of the term of art "generally accepted accounting principles" which may be inappropriate as applied to certain types of businesses, such as agricultural and farming operations. This revision is drawn from the Nebraska statute. Neb.Rev.Stat. § 30-3109 (1985).

§ 16309. Natural resources

16309. (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 discretion may determine, but the amount added to principal as an allowance for depletion may not exceed the lesser of (A) the percentage of gross receipts allowed as a deduction for depletion in computing taxable income for federal income tax purposes or (B) 50 percent of the net receipts remaining after payment of expenses, direct and indirect, computed without allowance for depletion.

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

Comment (1990). Section 16309 continues Section 16309 of the repealed Probate Code without change. See Sections 16080-16081 (duties with regard to discretionary powers). For the rule governing property subject to depletion that is not covered by Section 16309, see Section 16310.

Background on Section 16309 of Repealed Code

Section 16309 was added by 1986 Cal.Stat. ch. 820 § 40. For background on the provisions of this division, see the Comment to this division under the division heading.

Section 16309 continued former Civil Code Section 730.09 (repealed by 1986 Cal.Stat. ch. 820 § 2) with two changes:

(1) In subdivision (a)(3) the reference to "absolute discretion" was revised to read "discretion"; this revision made no substantive change. See Sections 16080-16081 (duties with regard to discretionary powers).

(2) The former reference to 27 and one-half percent of gross receipts in subdivision (a)(3) was replaced with a standard tied to federal tax law.

§ 16310. Property subject to depletion

16310. If the principal consists of property subject to depletion, other than property subject to Section 16309, including land from which merchantable timber may be removed and, 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 discretion may determine, but in no event shall the amount allocated to principal exceed a reasonable allowance for depletion or amortization.

Comment (1990). Section 16310 continues Section 16310 of the repealed Probate Code without change. See Sections 16080-16081 (duties with regard to discretionary powers).

Background on Section 16310 of Repealed Code

Section 16310 was added by 1986 Cal.Stat. ch. 820 § 40. The section continued former Civil Code Sections 730.10 (timber) and 730.11 (other property subject to depletion) (provisions repealed by 1986 Cal.Stat. ch. 820 § 2), except that the reference to "absolute discretion" was revised to read "discretion." This revision made no substantive change. See Sections 16080-16081 (duties with regard to discretionary powers). For background on the provisions of this division, see the Comment to this division under the division heading.

§ 16311. Underproductive property

16311. (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, real property acquired by or in lieu of a 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.

(d) This section does not apply to securities listed on a national securities exchange or traded over the counter if the securities are held in a broadly diversified portfolio designed to produce a reasonable return appropriate to the purposes of the trust.

Comment (1995). Subdivision (d) of Section 16311 resolves the conflict between the portfolio approach to investment decisions provided in Section 16047 and the underproductive property provision of Section 16311 as it applies to securities.

Comment (1990). Section 16311 continues Section 16311 of the repealed Probate Code without change. Subdivision (d) resolves the conflict between the portfolio approach to investment decisions provided in Section 16040(b) and the underproductive property provision of Section 16311 as it applies to securities.

Background on Section 16311 of Repealed Code

Section 16311 was added by 1986 Cal.Stat. ch. 820 § 40. Subdivisions (a), (b), and (c) continued former Civil Code Section 730.12 (repealed by 1986 Cal.Stat. ch. 820 § 2) without change. Subdivision (d) was a new provision. For background on the provisions of this division, see the Comment to this division under the division heading.

§ 16312. Charges against income and principal

16312. (a) After determining income and principal in accordance with the terms of the trust instrument or with this chapter, the trustee shall charge to income or principal expenses and other charges as provided in this section.

(b) 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, remainder beneficiary, or trustee, interest paid by the trustee, and ordinary repairs.

(2) The trustee in its 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.

(c) 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.

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

(1) Trustee's compensation not chargeable to income under paragraphs (4) and (5) of subdivision (b), 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 (b), 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 or proceeding 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 (b) and by Section 16308.

(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 remainder beneficiary have an interest, any amount apportioned to the trust, including penalties, even though the income beneficiary also has rights in the principal.

Comment (1990). Section 16312 continues Section 16312 of the repealed Probate Code without change. See Sections 16080-16081 (duties with regard to discretionary powers), 17200 et seq. (judicial proceedings concerning trusts).

Background on Section 16312 of Repealed Code

Section 16312 was added by 1986 Cal.Stat. ch. 820 § 40. For background on the provisions of this division, see the Comment to this division under the division heading.

Subdivision (a) continued subdivision (c) of former Civil Code Section 730.03 (repealed by 1986 Cal.Stat. ch. 820 § 2) without substantive change. Subdivisions (b)-(e) continued former Civil Code Section 730.13 (repealed by 1986 Cal.Stat. ch. 820 § 2) with the following changes:

(1) The reference to "absolute discretion" was revised to read "discretion"; this revision made no substantive change. See Sections 16080-16081 (duties with regard to discretionary powers).

(2) A reference to "proceeding" was added to subdivision (d)(2). See Section 17200 et seq. (judicial proceedings concerning trusts).

§ 16313. Depreciation or depletion; reserve or allowance

16313. The trustee is not required to set aside a reserve or allowance from trust income for depreciation or depletion of, or to amortize, any trust property unless the trust instrument expressly requires a reserve or allowance. Nothing in this chapter prevents a trustee in its discretion from establishing a reserve or allowance, or from continuing any previous practice of maintaining a reserve or allowance.

Comment (1990). Section 16313 continues Section 16313 of the repealed Probate Code without change.

Background on Section 16313 of Repealed Code

Section 16313 was added by 1986 Cal.Stat. ch. 820 § 40. The section continued the first sentence and the first part of the second sentence of former Civil Code Section 730.14 (repealed by 1986 Cal.Stat. ch. 820 § 2) without substantive change. For background on the provisions of this division, see the Comment to this division under the division heading.

§ 16314. Gifts; income and interest

16314. (a) A specific gift, a general pecuniary gift, an annuity, or a gift for maintenance distributable under a trust carries with it income and bears interest in the same manner as a specific devise, a general pecuniary devise, an annuity, or a devise for maintenance under a will set forth in Chapter 8 (commencing with Section 12000) of Part 10 of Division 7.

(b) For the purpose of this section, a reference in Chapter 8 (commencing with Section 12000) of Part 10 of Division 7 to the date of the testator's death means the date of the settlor's death or other event upon which the distributee's right to receive the gift occurs.

Comment (1992). Subdivision (a) of Section 16314 is amended to make clear that the policy of this section is to apply to trusts the same rules that apply to estates. Thus, the one-year delay rule applicable to interest on distributions from decedents' estates under Chapter 8 (commencing with Section 12000) of Part 10 of Division 7 also applies to trust distributions, whether the right to the distribution arises on the settlor's death or on the occurrence of some other event. In effect, this section provides a one-year grace period within which the trustee may pay pecuniary gifts without interest whether or not the event giving rise to the right to distribution is the death of the settlor. The rate of interest payable on trust distributions parallels the rate of interest payable in probate administration. See Section 12001 (rate of interest). The trust instrument may vary the rules provided in this section. See Section 16302.

This amendment is intended as a technical, nonsubstantive clarification of the existing rule and applies to the extent provided in Section 16315 (application to trust created before July 1, 1989). See Section 3(c).

Comment (1990). Section 16314 restates Section 16314 of the repealed Probate Code with a clarifying change in subdivision (b). Cf. Section 21120(b) ("pecuniary gift" defined). The rate of interest payable on trust distributions parallels that payable in probate administration. See Section 12001 (rate of interest). The trust instrument may vary the rules provided in this section. See Section 16302. As to the applicability of Section 16314 to a trust created before July 1, 1989, see Section 16315. As to the application of any amendments made after that date, see Section 3.

Background on Section 16314 of Repealed Code

Section 16314 was a new provision added by 1988 Cal.Stat. ch. 1199 § 107. For background on the provisions of this division, see the Comment to this division under the division heading.

§ 16315. Trusts created before July 1, 1989; application of changes

16315. The changes made in Sections 16304 and 16305, and the addition of Section 16314, by Chapter 1199 of the Statutes of 1988 apply to a trust created before July 1, 1989, but the changes and addition apply to the trust as if created on that date and do not affect any aspect of the trust administration that occurred, or rights of beneficiaries that existed, before that date.

Comment (1990). Section 16315 continues Section 16315 of the repealed Probate Code with a technical change. Section 16315 is subject to contrary provisions in the trust instrument. See Section 16302 (duty of trustee as to receipts and expenditures).

Background on Section 16315 of Repealed Code

Section 16315 was a new provision added by 1988 Cal.Stat. ch. 1199 § 107.3. For background on this section, see Communication from the California Law Revision Commission Concerning Assembly Bill 2841, 19 Cal.L.Revision Comm'n Reports 1201, 1249 (1988).

UNIFORM PRINCIPAL AND INCOME ACT (1997)

Drafted by the

NATIONAL CONFERENCE OF COMMISSIONERS
ON UNIFORM STATE LAWS

and by it

APPROVED AND RECOMMENDED FOR ENACTMENT
IN ALL THE STATES

at its

ANNUAL CONFERENCE
MEETING IN ITS ONE-HUNDRED-AND-SIXTH YEAR
IN SACRAMENTO, CALIFORNIA
JULY 25 – AUGUST 1, 1997

WITH PREFATORY NOTE AND COMMENTS

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March 5, 1998

UNIFORM PRINCIPAL AND INCOME ACT (1997)

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UNIFORM PRINCIPAL AND INCOME ACT (1997)

PREFATORY NOTE

This revision of the 1931 Uniform Principal and Income Act and the 1962 Revised Uniform Principal and Income Act has two purposes.

One purpose is to revise the 1931 and the 1962 Acts. Revision is needed to support the now widespread use of the revocable living trust as a will substitute, to change the rules in those Acts that experience has shown need to be changed, and to establish new rules to cover situations not provided for in the old Acts, including rules that apply to financial instruments invented since 1962.

The other purpose is to provide a means for implementing the transition to an investment regime based on principles embodied in the Uniform Prudent Investor Act, especially the principle of investing for total return rather than a certain level of "income" as traditionally perceived in terms of interest, dividends, and rents.

Revision of the 1931 and 1962 Acts

The prior Acts and this revision of those Acts deal with four questions affecting the rights of beneficiaries:

(1) How is income earned during the probate of an estate to be distributed to trusts and to persons who receive outright bequests of specific property, pecuniary gifts, and the residue?

(2) When an income interest in a trust begins (i.e., when a person who creates the trust dies or when she transfers property to a trust during life), what property is principal that will eventually go to the remainder beneficiaries and what is income?

(3) When an income interest ends, who gets the income that has been received but not distributed, or that is due but not yet collected, or that has accrued but is not yet due?

(4) After an income interest begins and before it ends, how should its receipts and disbursements be allocated to or between principal and income?

Changes in the traditional sections are of three types: new rules that deal with situations not covered by the prior Acts, clarification of provisions in the 1962 Act, and changes to rules in the prior Acts.

New rules. Issues addressed by some of the more significant new rules include:

(1) The application of the probate administration rules to revocable living trusts after the settlor's death and to other terminating trusts. Articles 2 and 3.

(2) The payment of interest or some other amount on the delayed payment of an outright pecuniary gift that is made pursuant to a trust agreement instead of a will when the agreement or state law does not provide for such a payment. Section 201(3).

(3) The allocation of net income from partnership interests acquired by the trustee other than from a decedent (the old Acts deal only with partnership interests acquired from a decedent). Section 401.

(4) An "unincorporated entity" concept has been introduced to deal with businesses operated by a trustee, including farming and livestock operations, and

investment activities in rental real estate, natural resources, timber, and derivatives. Section 403.

(5) The allocation of receipts from discount obligations such as zero-coupon bonds. Section 406(b).

(6) The allocation of net income from harvesting and selling timber between principal and income. Section 412.

(7) The allocation between principal and income of receipts from derivatives, options, and asset-backed securities. Sections 414 and 415.

(8) Disbursements made because of environmental laws. Section 502(a)(7).

(9) Income tax obligations resulting from the ownership of S corporation stock and interests in partnerships. Section 505.

(10) The power to make adjustments between principal and income to correct inequities caused by tax elections or peculiarities in the way the fiduciary income tax rules apply. Section 506.

Clarifications and changes in existing rules. A number of matters provided for in the prior Acts have been changed or clarified in this revision, including the following:

(1) An income beneficiary's estate will be entitled to receive only net income actually received by a trust before the beneficiary's death and not items of accrued income. Section 303.

(2) Income from a partnership is based on actual distributions from the partnership, in the same manner as corporate distributions. Section 401.

(3) Distributions from corporations and partnerships that exceed 20% of the entity's gross assets will be principal whether or not intended by the entity to be a partial liquidation. Section 401(d)(2).

(4) Deferred compensation is dealt with in greater detail in a separate section. Section 409.

(5) The 1962 Act rule for "property subject to depletion," (patents, copyrights, royalties, and the like), which provides that a trustee may allocate up to 5% of the asset's inventory value to income and the balance to principal, has been replaced by a rule that allocates 90% of the amounts received to principal and the balance to income. Section 410.

(6) The percentage used to allocate amounts received from oil and gas has been changed – 90% of those receipts are allocated to principal and the balance to income. Section 411.

(7) The unproductive property rule has been eliminated for trusts other than marital deduction trusts. Section 413.

(8) Charging depreciation against income is no longer mandatory, and is left to the discretion of the trustee. Section 503.

Coordination with the Uniform Prudent Investor Act

The law of trust investment has been modernized. See Uniform Prudent Investor Act (1994); Restatement (Third) of Trusts: Prudent Investor Rule (1992) (hereinafter Restatement of Trusts 3d: Prudent Investor Rule). Now it is time to update the principal and income allocation rules so the two bodies of doctrine can work well together. This revision deals conservatively with the tension between modern investment theory and traditional income allocation. The starting point is to use the traditional system. If prudent investing of all the assets in a trust viewed as a portfolio and traditional allocation effectuate the intent of the settlor, then nothing need be done. The Act, however, helps the trustee who has made a prudent, modern portfolio-based investment decision that has the initial effect of skewing return from all the assets under management, viewed as a portfolio, as between income and principal beneficiaries. The Act gives that trustee a power to reallocate the portfolio return suitably. To leave a trustee constrained by the traditional system would inhibit the trustee's ability to fully implement modern portfolio theory.

As to modern investing see, e.g., the Preface to, terms of, and Comments to the Uniform Prudent Investor Act (1994); the discussion and reporter's note by Edward C. Halbach, Jr. in Restatement of Trusts 3d: Prudent Investor Rule; John H. Langbein, The Uniform Prudent Investor Act and the Future of Trust Investing, 81 Iowa L. Rev. 641 (1996); Bevis Longstreth, Modern Investment Management and the Prudent Man Rule (1986); John H. Langbein & Richard A. Posner, The Revolution in Trust Investment Law, 62 A.B.A.J. 887 (1976); and Jeffrey N. Gordon, The Puzzling Persistence of the Constrained Prudent Man Rule, 62 N.Y.U. L. Rev. 52 (1987). See also R.A. Brearly, An Introduction to Risk and Return from Common Stocks (2d ed. 1983); Jonathan R. Macey, An Introduction to Modern Financial Theory (1991). As to the need for principal and income reform see, e.g., Joel C. Dobris, Real Return, Modern Portfolio Theory and College, University and Foundation Decisions on Annual Spending From Endowments: A Visit to the World of Spending Rules, 28 Real Prop., Prob., & Tr. J. 49 (1993); Joel C. Dobris, The Probate World at the End of the Century: Is a New Principal and Income Act in Your Future?, 28 Real Prop., Prob., & Tr. J. 393 (1993); and Kenneth L. Hirsch, Inflation and the Law of Trusts, 18 Real Prop., Prob., & Tr. J. 601 (1983). See also, Jerold I. Horn, The Prudent Investor Rule – Impact on Drafting and Administration of Trusts, 20 ACTEC Notes 26 (Summer 1994).

UNIFORM PRINCIPAL AND INCOME ACT (1997)

[ARTICLE] 1
DEFINITIONS AND FIDUCIARY DUTIES

SECTION 101. SHORT TITLE. This [Act] may be cited as the Uniform Principal and Income Act (1997).

SECTION 102. DEFINITIONS. In this [Act]:

(1) "Accounting period" means a calendar year unless another 12-month period is selected by a fiduciary. The term includes a portion of a calendar year or other 12-month period that begins when an income interest begins or ends when an income interest ends.

(2) "Beneficiary" includes, in the case of a decedent's estate, an heir [, legatee,] and devisee and, in the case of a trust, an income beneficiary and a remainder beneficiary.

(3) "Fiduciary" means a personal representative or a trustee. The term includes an executor, administrator, successor personal representative, special administrator, and a person performing substantially the same function.

(4) "Income" means money or property that a fiduciary receives as current return from a principal asset. The term includes a portion of receipts from a sale, exchange, or liquidation of a principal asset, to the extent provided in [Article] 4.

(5) "Income beneficiary" means a person to whom net income of a trust is or may be payable.

(6) "Income interest" means the right of an income beneficiary to receive all or part of net income, whether the terms of the trust require it to be distributed or authorize it to be distributed in the trustee's discretion.

(7) "Mandatory income interest" means the right of an income beneficiary to receive net income that the terms of the trust require the fiduciary to distribute.

(8) "Net income" means the total receipts allocated to income during an accounting period minus the disbursements made from income during the period, plus or minus transfers under this [Act] to or from income during the period.

(9) "Person" means an individual, corporation, business trust, estate, trust, partnership, limited liability company, association, joint venture, government; governmental subdivision, agency, or instrumentality; public corporation, or any other legal or commercial entity.

(10) "Principal" means property held in trust for distribution to a remainder beneficiary when the trust terminates.

(11) "Remainder beneficiary" means a person entitled to receive principal when an income interest ends.

(12) "Terms of a trust" means the manifestation of the intent of a settlor or decedent with respect to the trust, expressed in a manner that admits of its proof in a judicial proceeding, whether by written or spoken words or by conduct.

(13) "Trustee" includes an original, additional, or successor trustee, whether or not appointed or confirmed by a court.

Comment

"Income beneficiary." The definitions of income beneficiary (Section 102(5)) and income interest (Section 102(6)) cover both mandatory and discretionary beneficiaries and interests. There are no definitions for "discretionary income beneficiary" or "discretionary income interest" because those terms are not used in the Act.

Inventory value. There is no definition for inventory value in this Act because the provisions in which that term was used in the 1962 Act have either been eliminated (in the case of the underproductive property provision) or changed in a way that eliminates the need for the term (in the case of bonds and other money obligations, property subject to depletion, and the method for determining entitlement to income distributed from a probate estate).

"**Net income."** The reference to "transfers under this Act to or from income" means transfers made under Sections 104(a), 412(b), 502(b), 503(b), 504(a), and 506.

"Terms of a trust." This term was chosen in preference to "terms of the trust instrument" (the phrase used in the 1962 Act) to make it clear that the Act applies to oral trusts as well as those whose terms are expressed in written documents. The definition is based on the Restatement (Second) of Trusts § 4 (1959) and the Restatement (Third) of Trusts § 4 (Tent. Draft No. 1, 1996). Constructional preferences or rules would also apply, if necessary, to determine the terms of the trust.

SECTION 103. FIDUCIARY DUTIES; GENERAL PRINCIPLES.

(a) In allocating receipts and disbursements to or between principal and income, and with respect to any matter within the scope of [Articles] 2 and 3, a fiduciary:

(1) shall administer a trust or estate in accordance with the terms of the trust or the will, even if there is a different provision in this [Act];

(2) may administer a trust or estate by the exercise of a discretionary power of administration given to the fiduciary by the terms of the trust or the will, even if the exercise of the power produces a result different from a result required or permitted by this [Act];

(3) shall administer a trust or estate in accordance with this [Act] if the terms of the trust or the will do not contain a different provision or do not give the fiduciary a discretionary power of administration; and

(4) shall add a receipt or charge a disbursement to principal to the extent that the terms of the trust and this [Act] do not provide a rule for allocating the receipt or disbursement to or between principal and income.

(b) In exercising the power to adjust under Section 104(a) or a discretionary power of administration regarding a matter within the scope of this [Act], whether granted by the terms of a trust, a will, or this [Act], a fiduciary shall administer a trust or estate impartially, based on what is fair and reasonable to all of the beneficiaries, except to the extent that the terms of the trust or the will clearly manifest an intention that the fiduciary shall or may favor one or more of the beneficiaries. A determination in accordance with this [Act] is presumed to be fair and reasonable to all of the beneficiaries.

Comment

Prior Act. The rule in Section 2(a) of the 1962 Act is restated in Section 103(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 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) states that it also applies to matters within the scope of Articles 2 and 3. Section 103(a)(2) incorporates the rule in Section 2(b) of the 1962 Act 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.

The Act deletes the language that appears at the end of 1962 Act Section 2(a)(3) – ”and in view of the manner in which men of ordinary prudence, discretion and judgment would act in the management of their affairs” – because persons of ordinary prudence, discretion and judgment, acting in the management of their own affairs do not normally think in terms of the interests of successive beneficiaries. If there is an analogy to an individual’s decision-making process, it is probably the individual’s decision to spend or to save, but this is not a useful guideline for trust administration. No case has been found in which a court has relied on the “prudent man” rule of the 1962 Act.

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) 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), after considering the return from the portfolio as a whole, the trustee may make an appropriate adjustment under Section 104(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). 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) 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.

SECTION 104. TRUSTEE'S POWER TO ADJUST.

(a) A trustee may adjust between principal and income to the extent the trustee considers necessary if the trustee invests and manages trust assets as a prudent investor, the terms of the trust describe the amount that may or must be distributed to a beneficiary by referring to the trust's income, and the trustee determines, after applying the rules in Section 103(a), that the trustee is unable to comply with Section 103(b).

(b) In deciding whether and to what extent to exercise the power conferred by subsection (a), a trustee shall consider all factors relevant to the trust and its beneficiaries, including the following factors to the extent they are relevant:

(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 the other sections of this [Act] 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 terms of the trust give 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.

(c) A trustee may not make an adjustment:

(1) that diminishes the income interest in a trust that requires all of the income to be paid at least annually to a surviving spouse and for which an estate tax or gift tax marital deduction would be allowed, in whole or in part, if the trustee did not have the power to make the adjustment;

(2) that reduces the actuarial value of the income interest in a trust to which a person transfers property with the intent to qualify for a gift tax exclusion;

(3) that changes 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 the terms of a trust unless both income and principal are so set aside;

(5) if possessing or exercising the power to make an adjustment causes an individual to be treated as the owner of all or part of the trust 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) if possessing or exercising the power to make an adjustment causes 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) if the trustee is a beneficiary of the trust; or

(8) if the trustee is not a beneficiary, but the adjustment would benefit the trustee directly or indirectly.

(d) If subsection (c)(5), (6), (7), or (8) 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 terms of the trust.

(e) 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 if the trustee is uncertain about whether possessing or exercising the power will cause a result described in subsection (c)(1) through (6) or (c)(8) or 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 (c). The release may be permanent or for a specified period, including a period measured by the life of an individual.

(f) Terms of a trust that limit the power of a trustee to make an adjustment between principal and income do not affect the application of this section unless it is clear from the terms of the trust that the terms are intended to deny the trustee the power of adjustment conferred by subsection (a).

Comment

Purpose and Scope of Provision. The purpose of Section 104 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) 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), that he is unable to comply with Section 103(b). In deciding whether and to what extent to exercise the power to adjust, the trustee is required to consider the factors described in Section 104(b), but the trustee may not make an adjustment in circumstances described in Section 104(c).

Section 104 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) is the requirement in Section 103(b) that "a fiduciary must administer a trust or estate impartially, based on what is fair and reasonable to all of the beneficiaries, except to the extent that the terms of the trust or the will clearly manifest 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 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 will be an important tool in trust administration.

Three conditions to the exercise of the power to adjust. The first of the three conditions 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 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, the trustee must first meet the requirements of Section 103(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).

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. The power to adjust under Section 104(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 eliminates the underproductive property rule in all cases other than trusts for which a marital deduction is allowed, and it applies to a marital deduction trust if the trust's assets "consist substantially of property that does not provide the surviving 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) 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.*

Factors to consider in exercising the power to adjust. Section 104(b) requires 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 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." 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); 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) is to preserve tax benefits that may have been an important purpose for creating the trust. Subsections (c)(5), (6), and (8) deny the power to adjust in the circumstances described in those subsections in order to prevent adverse tax consequences, and subsection (c)(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), 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 surviving 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 surviving spouse. Subsection (c)(1) applies to a trust that qualifies for the marital deduction because the surviving 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) 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) 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). Subsection (c)(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) does not prevent a trustee from making an adjustment under Section 104(a) in determining the amount of the trust's income.

If subsection (c)(5), (6), (7), or (8), prevents a trustee from exercising the power to adjust, subsection (d) 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) 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) to release just the power to adjust from income to principal.

Trust terms that limit a power to adjust. Section 104(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) 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:

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 factors in Section 104(b), 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, 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) 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. 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) 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). After considering the return from the trust's portfolio as a whole and other relevant factors described in Section 104(b), T may exercise the power to adjust under Section 104(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).

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) and the other one-half would have been paid from principal under Section 502(a)(1). After considering the total return from the portfolio as a whole and other relevant factors described in Section 104(b), T may exercise its power to adjust under Section 104(a) by transferring $1,000, or half of the trust's proportionate share of the fee, from principal to income.

[ARTICLE] 2
DECEDENT'S ESTATE OR TERMINATING INCOME INTEREST

SECTION 201. DETERMINATION AND DISTRIBUTION OF NET INCOME. After a decedent dies, in the case of an estate, or after an income interest in a trust ends, the following rules apply:

(1) A fiduciary of an estate or of a terminating income interest shall determine the amount of net income and net principal receipts received from property specifically given to a beneficiary under the rules in [Articles] 3 through 5 which apply to trustees and the rules in paragraph (5). The fiduciary shall distribute the net income and net principal receipts to the beneficiary who is to receive the specific property.

(2) A fiduciary shall determine the remaining net income of a decedent's estate or a terminating income interest under the rules in [Articles] 3 through 5 which apply to trustees and by:

(A) including in net income all income from property used to discharge liabilities;

(B) paying from income or principal, in the fiduciary's discretion, fees of attorneys, accountants, and fiduciaries; court costs and other expenses of administration; and interest on death taxes, but the fiduciary may pay those expenses from income of property passing to a trust for which the fiduciary claims an estate tax marital or charitable deduction only to the extent that the payment of those expenses from income will not cause the reduction or loss of the deduction; and

(C) paying from principal all other disbursements made or incurred in connection with the settlement of a decedent's estate or the winding up of a terminating income interest, including debts, funeral expenses, disposition of remains, family allowances, and death taxes and related penalties that are apportioned to the estate or terminating income interest by the will, the terms of the trust, or applicable law.

(3) A fiduciary shall distribute to a beneficiary who receives a pecuniary amount outright the interest or any other amount provided by the will, the terms of the trust, or applicable law from net income determined under paragraph (2) or from principal to the extent that net income is insufficient. If a beneficiary is to receive a pecuniary amount outright from a trust after an income interest ends and no interest or other amount is provided for by the terms of the trust or applicable law, the fiduciary shall distribute the interest or other amount to which the beneficiary would be entitled under applicable law if the pecuniary amount were required to be paid under a will.

(4) A fiduciary shall distribute the net income remaining after distributions required by paragraph (3) in the manner described in Section 202 to all other beneficiaries, including a beneficiary who receives a pecuniary amount in trust, even if the beneficiary holds an unqualified power to withdraw assets from the trust or other presently exercisable general power of appointment over the trust.

(5) A fiduciary may not reduce principal or income receipts from property described in paragraph (1) because of a payment described in Section 501 or 502 to the extent that the will, the terms of the trust, or applicable law requires the fiduciary to make the payment from assets other than the property or to the extent that the fiduciary recovers or expects to recover the payment from a third party. The net income and principal receipts from the property are determined by including all of the amounts the fiduciary receives or pays with respect to the property, whether those amounts accrued or became due before, on, or after the date of a decedent's death or an income interest's terminating event, and by making a reasonable provision for amounts that the fiduciary believes the estate or terminating income interest may become obligated to pay after the property is distributed.

Comment

Terminating income interests and successive income interests. A trust that provides for a single income beneficiary and an outright distribution of the remainder ends when the income interest ends. A more complex trust may have a number of income interests, either concurrent or successive, and the trust will not necessarily end when one of the income interests ends. For that reason, the Act speaks in terms of income interests ending and beginning rather than trusts ending and beginning. When an income interest in a trust ends, the trustee's powers continue during the winding up period required to complete its administration. A terminating income interest is one that has ended but whose administration is not complete.

If two or more people are given the right to receive specified percentages or fractions of the income from a trust concurrently and one of the concurrent interests ends, e.g., when a beneficiary dies, the beneficiary's income interest ends but the trust does not. Similarly, when a trust with only one income beneficiary ends upon the beneficiary's death, the trust instrument may provide that part or all of the trust assets shall continue in trust for another income beneficiary. While it is common to think and speak of this (and even to characterize it in a trust instrument) as a "new" trust, it is a continuation of the original trust for a remainder beneficiary who has an income interest in the trust assets instead of the right to receive them outright. For purposes of this Act, this is a successive income interest in the same trust. The fact that a trust may or may not end when an income interest ends is not significant for purposes of this Act.

If the assets that are subject to a terminating income interest pass to another trust because the income beneficiary exercises a general power of appointment over the trust assets, the recipient trust would be a new trust; and if they pass to another trust because the beneficiary exercises a nongeneral power of appointment over the trust assets, the recipient trust might be a new trust in some States (see 5A Austin W. Scott & William F. Fratcher, The Law of Trusts § 640, at 483 (4th ed. 1989)); but for purposes of this Act a new trust created in these circumstances is also a successive income interest.

Gift of a pecuniary amount. Section 201(3) and (4) provide different rules for an outright gift of a pecuniary amount and a gift in trust of a pecuniary amount; this is the same approach used in Section 5(b)(2) of the 1962 Act.

Interest on pecuniary amounts. Section 201(3) provides that the beneficiary of an outright pecuniary amount is to receive the interest or other amount provided by applicable law if there is no provision in the will or the terms of the trust. Many States have no applicable law that provides for interest or some other amount to be paid on an outright pecuniary gift under an inter vivos trust; this section provides that in such a case the interest or other amount to be paid shall be the same as the interest or other amount required to be paid on testamentary pecuniary gifts. This provision is intended to accord gifts under inter vivos instruments the same treatment as testamentary gifts. The various state authorities that provide for the amount that a beneficiary of an outright pecuniary amount is entitled to receive are collected in Richard B. Covey, Marital Deduction and Credit Shelter Dispositions and the Use of Formula Provisions, App. B (Supp. 1997).

Administration expenses and interest on death taxes. Under Section 201(2)(B) a fiduciary may pay administration expenses and interest on death taxes from either income or principal. An advantage of permitting the fiduciary to choose the source of the payment is that, if the fiduciary's decision is consistent with the decision to deduct these expenses for income tax purposes or estate tax purposes, it eliminates the need to adjust between principal and income that may arise when, for example, an expense that is paid from principal is deducted for income tax purposes or an expense that is paid from income is deducted for estate tax purposes.

The United States Supreme Court has considered the question of whether an estate tax marital deduction or charitable deduction should be reduced when administration expenses are paid from income produced by property passing in trust for a surviving spouse or for charity and deducted for income tax purposes. The Court rejected the IRS position that administration expenses properly paid from income under the terms of the trust or state law must reduce the amount of a marital or charitable transfer, and held that the value of the transferred property is not reduced for estate tax purposes unless the administration expenses are material in light of the income the trust corpus could have been expected to generate. *Commissioner v. Estate of Otis C. Hubert*, 117 S.Ct. 1124 (1997). The provision in Section 201(2)(B) permits a fiduciary to pay and deduct administration expenses from income only to the extent that it will not cause the reduction or loss of an estate tax marital or charitable contributions deduction, which means that the limit on the amount payable from income will be established eventually by Treasury Regulations.

Interest on estate taxes. The IRS agrees that interest on estate and inheritance taxes may be deducted for income tax purposes without having to reduce the estate tax deduction for amounts passing to a charity or surviving spouse, whether the interest is paid from principal or income. Rev. Rul. 93-48, 93-2 C.B. 270. For estates of persons who died before 1998, a fiduciary may not want to deduct for income tax purposes interest on estate tax that is deferred under Section 6166 or 6163 because deducting that interest for estate tax purposes may produce more beneficial results, especially if the estate has little or no income or the income tax bracket is significantly lower than the estate tax bracket. For estates of persons who die after 1997, no estate tax or income tax deduction will be allowed for interest paid on estate tax that is deferred under Section 6166. However, interest on estate tax deferred under Section 6163 will continue to be deductible for both purposes, and interest on estate tax deficiencies will continue to be deductible for estate tax purposes if an election under Section 6166 is not in effect.

Under the 1962 Act, Section 13(c)(5) charges interest on estate and inheritance taxes to principal. The 1931 Act has no provision. Section 501(3) of this Act provides that, except to the extent provided in Section 201(2)(B) or (C), all interest must be paid from income.

SECTION 202. DISTRIBUTION TO RESIDUARY AND REMAINDER BENEFICIARIES.

(a) Each beneficiary described in Section 201(4) is entitled to receive a portion of the net income equal to the beneficiary's fractional interest in undistributed principal assets, using values as of the distribution date. If a fiduciary makes more than one distribution of assets to beneficiaries to whom this section applies, each beneficiary, including one who does not receive part of the distribution, is entitled, as of each distribution date, to the net income the fiduciary has received after the date of death or terminating event or earlier distribution date but has not distributed as of the current distribution date.

(b) In determining a beneficiary's share of net income, the following rules apply:

(1) The beneficiary is entitled to receive a portion of the net income equal to the beneficiary's fractional interest in the undistributed principal assets immediately before the distribution date, including assets that later may be sold to meet principal obligations.

(2) The beneficiary's fractional interest in the undistributed principal assets must be calculated without regard to property specifically given to a beneficiary and property required to pay pecuniary amounts not in trust.

(3) The beneficiary's fractional interest in the undistributed principal assets must be calculated on the basis of the aggregate value of those assets as of the distribution date without reducing the value by any unpaid principal obligation.

(4) The distribution date for purposes of this section may be the date as of which the fiduciary calculates the value of the assets if that date is reasonably near the date on which assets are actually distributed.

(c) If a fiduciary does not distribute all of the collected but undistributed net income to each person as of a distribution date, the fiduciary shall maintain appropriate records showing the interest of each beneficiary in that net income.

(d) A trustee may apply the rules in this section, to the extent that the trustee considers it appropriate, to net gain or loss realized after the date of death or terminating event or earlier distribution date from the disposition of a principal asset if this section applies to the income from the asset.

Comment

Relationship to prior Acts. Section 202 retains the concept in Section 5(b)(2) of the 1962 Act that the residuary legatees of estates are to receive net income earned during the period of administration on the basis of their proportionate interests in the undistributed assets when distributions are made. It changes the basis for determining their proportionate interests by using asset values as of a date reasonably near the time of distribution instead of inventory values; it extends the application of these rules to distributions from terminating trusts; and it extends these rules to gain or loss realized from the disposition of assets during administration, an omission in the 1962 Act that has been noted by several commentators. See, e.g., Richard B. Covey, Marital Deduction and Credit Shelter Dispositions and the Use of Formula Provisions 80 (1984 & Supp. 1997); Thomas H. Cantrill, Fractional or Percentage Residuary Bequests: Allocation of Postmortem Income, Gain and Unrealized Appreciation, 10 Prob. Notes 322, 327 (1985).

[ARTICLE] 3
APPORTIONMENT AT BEGINNING AND END OF INCOME INTEREST

SECTION 301. WHEN RIGHT TO INCOME BEGINS AND ENDS.

(a) An income beneficiary is entitled to net income from the date on which the income interest begins. An income interest begins on the date specified in the terms of the trust or, if no date is specified, on the date an asset becomes subject to a trust or successive income interest.

(b) An asset becomes subject to a trust:

(1) on the date it is transferred to the trust in the case of an asset that is transferred to a trust during the transferor's life;

(2) on the date of a testator's death in the case of an asset that becomes subject to a trust by reason of a will, even if there is an intervening period of administration of the testator's estate; or

(3) on the date of an individual's death in the case of an asset that is transferred to a fiduciary by a third party because of the individual's death.

(c) An asset becomes subject to a successive income interest on the day after the preceding income interest ends, as determined under subsection (d), even if there is an intervening period of administration to wind up the preceding income interest.

(d) An income interest ends on the day before an income beneficiary dies or another terminating event occurs, or on the last day of a period during which there is no beneficiary to whom a trustee may distribute income.

Comment

Period during which there is no beneficiary. The purpose of the second part of subsection (d) is to provide that, at the end of a period during which there is no beneficiary to whom a trustee may distribute income, the trustee must apply the same apportionment rules that apply when a mandatory income interest ends. This provision would apply, for example, if a settlor creates a trust for grandchildren before any grandchildren are born. When the first grandchild is born, the period preceding the date of birth is treated as having ended, followed by a successive income interest, and the apportionment rules in Sections 302 and 303 apply accordingly if the terms of the trust do not contain different provisions.

SECTION 302. APPORTIONMENT OF RECEIPTS AND DISBURSEMENTS WHEN DECEDENT DIES OR INCOME INTEREST BEGINS.

(a) A trustee shall allocate an income receipt or disbursement other than one to which Section 201(1) applies to principal if its due date occurs before a decedent dies in the case of an estate or before an income interest begins in the case of a trust or successive income interest.

(b) A trustee shall allocate an income receipt or disbursement to income if its due date occurs on or after the date on which a decedent dies or an income interest begins and it is a periodic due date. An income receipt or disbursement must be treated as accruing from day to day if its due date is not periodic or it has no due date. The portion of the receipt or disbursement accruing before the date on which a decedent dies or an income interest begins must be allocated to principal and the balance must be allocated to income.

(c) An item of income or an obligation is due on the date the payer is required to make a payment. If a payment date is not stated, there is no due date for the purposes of this [Act]. Distributions to shareholders or other owners from an entity to which Section 401 applies are deemed to be due on the date fixed by the entity for determining who is entitled to receive the distribution or, if no date is fixed, on the declaration date for the distribution. A due date is periodic for receipts or disbursements that must be paid at regular intervals under a lease or an obligation to pay interest or if an entity customarily makes distributions at regular intervals.

Comment

Prior Acts. Professor Bogert stated that "Section 4 of the [1962] Act makes a change with respect to the apportionment of the income of trust property not due until after the trust began but which accrued in part before the commencement of the trust. It treats such income as to be credited entirely to the income account in the case of a living trust, but to be apportioned between capital and income in the case of a testamentary trust. The [1931] Act apportions such income in the case of both types of trusts, except in the case of corporate dividends." George G. Bogert, The Revised Uniform Principal and Income Act, 38 Notre Dame Law. 50, 52 (1962). The 1962 Act also provides that an asset passing to an inter vivos trust by a bequest in the settlor's will is governed by the rule that applies to a testamentary trust, so that different rules apply to assets passing to an inter vivos trust depending upon whether they were transferred to the trust during the settlor's life or by his will.

Having several different rules that apply to similar transactions is confusing. In order to simplify administration, Section 302 applies the same rule to inter vivos trusts (revocable and irrevocable), testamentary trusts, and assets that become subject to an inter vivos trust by a testamentary bequest.

Periodic payments. Under Section 302, a periodic payment is principal if it is due but unpaid before a decedent dies or before an asset becomes subject to a trust, but the next payment is allocated entirely to income and is not apportioned. Thus, periodic receipts such as rents, dividends, interest, and annuities, and disbursements such as the interest portion of a mortgage payment, are not apportioned. This is the original common law rule. Edwin A. Howes, Jr., The American Law Relating to Income and Principal 70 (1905). In trusts in which a surviving spouse is dependent upon a regular flow of cash from the decedent's securities portfolio, this rule will help to maintain payments to the spouse at the same level as before the settlor's death. Under the 1962 Act, the pre-death portion of the first periodic payment due after death is apportioned to principal in the case of a testamentary trust or securities bequeathed by will to an inter vivos trust.

Nonperiodic payments. Under the second sentence of Section 302(b), interest on an obligation that does not provide a due date for the interest payment, such as interest on an income tax refund, would be apportioned to principal to the extent it accrues before a person dies or an income interest begins unless the obligation is specifically given to a devisee or remainder beneficiary, in which case all of the accrued interest passes under Section 201(1) to the person who receives the obligation. The same rule applies to interest on an obligation that has a due date but does not provide for periodic payments. If there is no stated interest on the obligation, such as a zero coupon bond, and the proceeds from the obligation are received more than one year after it is purchased or acquired by the trustee, the entire amount received is principal under Section 406.

SECTION 303. APPORTIONMENT WHEN INCOME INTEREST ENDS.

(a) In this section, "undistributed income" means net income received before the date on which an income interest ends. The term does not include an item of income or expense that is due or accrued or net income that has been added or is required to be added to principal under the terms of the trust.

(b) When a mandatory income interest ends, the trustee shall pay to a mandatory income beneficiary who survives that date, or the estate of a deceased mandatory income beneficiary whose death causes the interest to end, the beneficiary's share of the undistributed income that is not disposed of under the terms of the trust unless the beneficiary has an unqualified power to revoke more than five percent of the trust immediately before the income interest ends. In the latter case, the undistributed income from the portion of the trust that may be revoked must be added to principal.

(c) When a trustee's obligation to pay a fixed annuity or a fixed fraction of the value of the trust's assets ends, the trustee shall prorate the final payment if and to the extent required by applicable law to accomplish a purpose of the trust or its settlor relating to income, gift, estate, or other tax requirements.

Comment

Prior Acts. Both the 1931 Act (Section 4) and the 1962 Act (Section 4(d)) provide that a deceased income beneficiary's estate is entitled to the undistributed income. The Drafting Committee concluded that this is probably not what most settlors would want, and that, with respect to undistributed income, most settlors would favor the income beneficiary first, the remainder beneficiaries second, and the income beneficiary's heirs last, if at all. However, it decided not to eliminate this provision to avoid causing disputes about whether the trustee should have distributed collected cash before the income beneficiary died.

Accrued periodic payments. Under the prior Acts, an income beneficiary or his estate is entitled to receive a portion of any payments, other than dividends, that are due or that have accrued when the income interest terminates. The last sentence of subsection (a) changes that rule by providing that such items are not included in undistributed income. The items affected include periodic payments of interest, rent, and dividends, as well as items of income that accrue over a longer period of time; the rule also applies to expenses that are due or accrued.

Example – accrued periodic payments. The rules in Section 302 and Section 303 work in the following manner: Assume that a periodic payment of rent that is due on July 20 has not been paid when an income interest ends on July 30; the successive income interest begins on July 31, and the rent payment that was due on July 20 is paid on August 3. Under Section 302(a), the July 20 payment is added to the principal of the successive income interest when received. Under Section 302(b), the entire periodic payment of rent that is due on August 20 is income when received by the successive income interest. Under Section 303, neither the income beneficiary of the terminated income interest nor the beneficiary's estate is entitled to any part of either the July 20 or the August 20 payments because neither one was received before the income interest ended on July 30. The same principles apply to expenses of the trust.

Beneficiary with an unqualified power to revoke. The requirement in subsection (b) to pay undistributed income to a mandatory income beneficiary or her estate does not apply to the extent the beneficiary has an unqualified power to revoke more than five percent of the trust immediately before the income interest ends. Without this exception, subsection (b) would apply to a revocable living trust whose settlor is the mandatory income beneficiary during her lifetime, even if her will provides that all of the assets in the probate estate are to be distributed to the trust.

If a trust permits the beneficiary to withdraw all or a part of the trust principal after attaining a specified age and the beneficiary attains that age but fails to withdraw all of the principal that she is permitted to withdraw, a trustee is not required to pay her or her estate the undistributed income attributable to the portion of the principal that she left in the trust. The assumption underlying this rule is that the beneficiary has either provided for the disposition of the trust assets (including the undistributed income) by exercising a power of appointment that she has been given or has not withdrawn the assets because she is willing to have the principal and undistributed income be distributed under the terms of the trust. If the beneficiary has the power to withdraw 25% of the trust principal, the trustee must pay to her or her estate the undistributed income from the 75% that she cannot withdraw.

[ARTICLE] 4
ALLOCATION OF RECEIPTS DURING ADMINISTRATION OF TRUST

[PART 1
RECEIPTS FROM ENTITIES]

SECTION 401. CHARACTER OF RECEIPTS.

(a) In this section, "entity" means a corporation, partnership, limited liability company, regulated investment company, real estate investment trust, common trust fund, or any other organization in which a trustee has an interest other than a trust or estate to which Section 402 applies, a business or activity to which Section 403 applies, or an asset-backed security to which Section 415 applies.

(b) Except as otherwise provided in this section, a trustee shall allocate to income money received from an entity.

(c) A trustee shall allocate the following receipts from an entity to principal:

(1) property other than money;

(2) money received in one distribution or a series of related distributions in exchange for part or all of a trust's interest in the entity;

(3) money received in total or partial liquidation of the entity; and

(4) money received from an entity that is a regulated investment company or a real estate investment trust if the money distributed is a capital gain dividend for federal income tax purposes.

(d) Money is received in partial liquidation:

(1) to the extent that the entity, at or near the time of a distribution, indicates that it is a distribution in partial liquidation; or

(2) if the total amount of money and property received in a distribution or series of related distributions is greater than 20 percent of the entity's gross assets, as shown by the entity's year-end financial statements immediately preceding the initial receipt.

(e) Money is not received in partial liquidation, nor may it be taken into account under subsection (d)(2), to the extent that it does not exceed the amount of income tax that a trustee or beneficiary must pay on taxable income of the entity that distributes the money.

(f) A trustee may rely upon a statement made by an entity about the source or character of a distribution if the statement is made at or near the time of distribution by the entity's board of directors or other person or group of persons authorized to exercise powers to pay money or transfer property comparable to those of a corporation's board of directors.

Comment

Entities to which Section 401 applies. The reference to partnerships in Section 401(a) is intended to include all forms of partnerships, including limited partnerships, limited liability partnerships, and variants that have slightly different names and characteristics from State to State. The section does not apply, however, to receipts from an interest in property that a trust owns as a tenant in common with one or more co-owners, nor would it apply to an interest in a joint venture if, under applicable law, the trust's interest is regarded as that of a tenant in common.

Capital gain dividends. Under the Internal Revenue Code and the Income Tax Regulations, a "capital gain dividend" from a mutual fund or real estate investment trust is the excess of the fund's or trust's net long-term capital gain over its net short-term capital loss. As a result, a capital gain dividend does not include any net short-term capital gain, and cash received by a trust because of a net short-term capital gain is income under this Act.

Reinvested dividends. If a trustee elects (or continues an election made by its predecessor) to reinvest dividends in shares of stock of a distributing corporation or fund, whether evidenced by new certificates or entries on the books of the distributing entity, the new shares would be principal, but the trustee may determine, after considering the return from the portfolio as a whole, whether an adjustment under Section 104 is necessary as a result.

Distribution of property. The 1962 Act describes a number of types of property that would be principal if distributed by a corporation. This becomes unwieldy in a section that applies to both corporations and all other entities. By stating that principal includes the distribution of any property other than money, Section 401 embraces all of the items enumerated in Section 6 of the 1962 Act as well as any other form of nonmonetary distribution not specifically mentioned in that Act.

Partial liquidations. Under subsection (d)(1), any distribution designated by the entity as a partial liquidating distribution is principal regardless of the percentage of total assets that it represents. If a distribution exceeds 20% of the entity's gross assets, the entire distribution is a partial liquidation under subsection (d)(2) whether or not the entity describes it as a partial liquidation. In determining whether a distribution is greater than 20% of the gross assets, the portion of the distribution that does not exceed the amount of income tax that the trustee or a beneficiary must pay on the entity's taxable income is ignored.

Other large distributions. A cash distribution may be quite large (for example, more than 10% but not more than 20% of the entity's gross assets) and have characteristics that suggest it should be treated as principal rather than income. For example, an entity may have received cash from a source other than the conduct of its normal business operations because it sold an investment asset; or because it sold a business asset other than one held for sale to customers in the normal course of its business and did not replace it; or it borrowed a large sum of money and secured the repayment of the loan with a substantial asset; or a principal source of its cash was from assets such as mineral interests, 90% of which would have been allocated to principal if the trust had owned the assets directly. In such a case the trustee, after considering the total return from the portfolio as a whole and the income component of that return, may decide to exercise the power under Section 104(a) to make an adjustment between income and principal, subject to the limitations in Section 104(c).

SECTION 402. DISTRIBUTION FROM TRUST OR ESTATE. A trustee shall allocate to income an amount received as a distribution of income from a trust or an estate in which the trust has an interest other than a purchased interest, and shall allocate to principal an amount received as a distribution of principal from such a trust or estate. If a trustee purchases an interest in a trust that is an investment entity, or a decedent or donor transfers an interest in such a trust to a trustee, Section 401 or 415 applies to a receipt from the trust.

Comment

Terms of the distributing trust or estate. Under Section 103(a), a trustee is to allocate receipts in accordance with the terms of the recipient trust or, if there is no provision, in accordance with this Act. However, in determining whether a distribution from another trust or an estate is income or principal, the trustee should also determine what the terms of the distributing trust or estate say about the distribution – for example, whether they direct that the distribution, even though made from the income of the distributing trust or estate, is to be added to principal of the recipient trust. Such a provision should override the terms of this Act, but if the terms of the recipient trust contain a provision requiring such a distribution to be allocated to income, the trustee may have to obtain a judicial resolution of the conflict between the terms of the two documents.

Investment trusts. An investment entity to which the second sentence of this section applies includes a mutual fund, a common trust fund, a business trust or other entity organized as a trust for the purpose of receiving capital contributed by investors, investing that capital, and managing investment assets, including asset-backed security arrangements to which Section 415 applies. See John H. Langbein, The Secret Life of the Trust: The Trust as an Instrument of Commerce, 107 Yale L.J. 165 (1997).

SECTION 403. BUSINESS AND OTHER ACTIVITIES CONDUCTED BY TRUSTEE.

(a) If a trustee who conducts a business or other activity determines that it is in the best interest of all the beneficiaries to account separately for the business or activity instead of accounting for it as part of the trust’s general accounting records, the trustee may maintain separate accounting records for its transactions, whether or not its assets are segregated from other trust assets.

(b) A trustee who accounts separately for a business or other activity may determine the extent to which its net cash receipts must be retained for working capital, the acquisition or replacement of fixed assets, and other reasonably foreseeable needs of the business or activity, and the extent to which the remaining net cash receipts are accounted for as principal or income in the trust’s general accounting records. If a trustee sells assets of the business or other activity, other than in the ordinary course of the business or activity, the trustee shall account for the net amount received as principal in the trust's general accounting records to the extent the trustee determines that the amount received is no longer required in the conduct of the business.

(c) Activities for which a trustee may maintain separate accounting records include:

(1) retail, manufacturing, service, and other traditional business activities;

(2) farming;

(3) raising and selling livestock and other animals;

(4) management of rental properties;

(5) extraction of minerals and other natural resources;

(6) timber operations; and

(7) activities to which Section 414 applies.

Comment

Purpose and scope. The provisions in Section 403 are intended to give greater flexibility to a trustee who operates a business or other activity in proprietorship form rather than in a wholly-owned corporation (or, where permitted by state law, a single-member limited liability company), and to facilitate the trustee's ability to decide the extent to which the net receipts from the activity should be allocated to income, just as the board of directors of a corporation owned entirely by the trust would decide the amount of the annual dividend to be paid to the trust. It permits a trustee to account for farming or livestock operations, rental properties, oil and gas properties, timber operations, and activities in derivatives and options as though they were held by a separate entity. It is not intended, however, to permit a trustee to account separately for a traditional securities portfolio to avoid the provisions of this Act that apply to such securities.

Section 403 permits the trustee to account separately for each business or activity for which the trustee determines separate accounting is appropriate. A trustee with a computerized accounting system may account for these activities in a "subtrust"; an individual trustee may continue to use the business and record-keeping methods employed by the decedent or transferor who may have conducted the business under an assumed name. The intent of this section is to give the trustee broad authority to select business record-keeping methods that best suit the activity in which the trustee is engaged.

If a fiduciary liquidates a sole proprietorship or other activity to which Section 403 applies, the proceeds would be added to principal, even though derived from the liquidation of accounts receivable, because the proceeds would no longer be needed in the conduct of the business. If the liquidation occurs during probate or during an income interest's winding up period, none of the proceeds would be income for purposes of Section 201.

Separate accounts. A trustee may or may not maintain separate bank accounts for business activities that are accounted for under Section 403. A professional trustee may decide not to maintain separate bank accounts, but an individual trustee, especially one who has continued a decedent's business practices, may continue the same banking arrangements that were used during the decedent's lifetime. In either case, the trustee is authorized to decide to what extent cash is to be retained as part of the business assets and to what extent it is to be transferred to the trust's general accounts, either as income or principal.

[PART 2
RECEIPTS NOT NORMALLY APPORTIONED]

SECTION 404. PRINCIPAL RECEIPTS. A trustee shall allocate to principal:

(1) to the extent not allocated to income under this [Act], assets received from a transferor during the transferor's lifetime, a decedent's estate, a trust with a terminating income interest, or a payer under a contract naming the trust or its trustee as beneficiary;

(2) money or other property received from the sale, exchange, liquidation, or change in form of a principal asset, including realized profit, subject to this [article];

(3) amounts recovered from third parties to reimburse the trust because of disbursements described in Section 502(a)(7) or for other reasons to the extent not based on the loss of income;

(4) proceeds of property taken by eminent domain, but a separate award made for the loss of income with respect to an accounting period during which a current income beneficiary had a mandatory income interest is income;

(5) net income received in an accounting period during which there is no beneficiary to whom a trustee may or must distribute income; and

(6) other receipts as provided in [Part 3].

Comment

Eminent domain awards. Even though the award in an eminent domain proceeding may include an amount for the loss of future rent on a lease, if that amount is not separately stated the entire award is principal. The rule is the same in the 1931 and 1962 Acts.

SECTION 405. RENTAL PROPERTY. To the extent that a trustee accounts for receipts from rental property pursuant to this section, the trustee shall allocate to income an amount received as rent of real or personal property, including an amount received for cancellation or renewal of a lease. An amount received as a refundable deposit, including a security deposit or a deposit that is to be applied as rent for future periods, must be added to principal and held subject to the terms of the lease and is not available for distribution to a beneficiary until the trustee's contractual obligations have been satisfied with respect to that amount.

Comment

Application of Section 403. This section applies to the extent that the trustee does not account separately under Section 403 for the management of rental properties owned by the trust.

Receipts that are capital in nature. A portion of the payment under a lease may be a reimbursement of principal expenditures for improvements to the leased property that is characterized as rent for purposes of invoking contractual or statutory remedies for nonpayment. If the trustee is accounting for rental income under Section 405, a transfer from income to reimburse principal may be appropriate under Section 504 to the extent that some of the "rent" is really a reimbursement for improvements. This set of facts could also be a relevant factor for a trustee to consider under Section 104(b) in deciding whether and to what extent to make an adjustment between principal and income under Section 104(a) after considering the return from the portfolio as a whole.

SECTION 406. OBLIGATION TO PAY MONEY.

(a) An amount received as interest, whether determined at a fixed, variable, or floating rate, on an obligation to pay money to the trustee, including an amount received as consideration for prepaying principal, must be allocated to income without any provision for amortization of premium.

(b) A trustee shall allocate to principal an amount received from the sale, redemption, or other disposition of an obligation to pay money to the trustee more than one year after it is purchased or acquired by the trustee, including an obligation whose purchase price or value when it is acquired is less than its value at maturity. If the obligation matures within one year after it is purchased or acquired by the trustee, an amount received in excess of its purchase price or its value when acquired by the trust must be allocated to income.

(c) This section does not apply to an obligation to which Section 409, 410, 411, 412, 414, or 415 applies.

Comment

Variable or floating interest rates. The reference in subsection (a) to variable or floating interest rate obligations is intended to clarify that, even though an obligation's interest rate may change from time to time based upon changes in an index or other market indicator, an obligation to pay money containing a variable or floating rate provision is subject to this section and is not to be treated as a derivative financial instrument under Section 414.

Discount obligations. Subsection (b) applies to all obligations acquired at a discount, including short-term obligations such as U.S. Treasury Bills, long-term obligations such as U.S. Savings Bonds, zero-coupon bonds, and discount bonds that pay interest during part, but not all, of the period before maturity. Under subsection (b), the entire increase in value of these obligations is principal when the trustee receives the proceeds from the disposition unless the obligation, when acquired, has a maturity of less than one year. In order to have one rule that applies to all discount obligations, the Act eliminates the provision in the 1962 Act for the payment from principal of an amount equal to the increase in the value of U.S. Series E bonds. The provision for bonds that mature within one year after acquisition by the trustee is derived from the Illinois act. 760 ILCS 15/8 (1996).

Subsection (b) also applies to inflation-indexed bonds – any increase in principal due to inflation after issuance is principal upon redemption if the bond matures more than one year after the trustee acquires it; if it matures within one year, all of the increase, including any attributable to an inflation adjustment, is income.

Effect of Section 104. In deciding whether and to what extent to exercise the power to adjust between principal and income granted by Section 104(a), a relevant factor for the trustee to consider is the effect on the portfolio as a whole of having a portion of the assets invested in bonds that do not pay interest currently.

SECTION 407. INSURANCE POLICIES AND SIMILAR CONTRACTS.

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

(b) A trustee shall allocate to income proceeds of a contract that insures the trustee against loss of occupancy or other use by an income beneficiary, loss of income, or, subject to Section 403, loss of profits from a business.

(c) This section does not apply to a contract to which Section 409 applies.

[PART 3

RECEIPTS NORMALLY APPORTIONED]

SECTION 408. INSUBSTANTIAL ALLOCATIONS NOT REQUIRED. If a trustee determines that an allocation between principal and income required by Section 409, 410, 411, 412, or 415 is insubstantial, the trustee may allocate the entire amount to principal unless one of the circumstances described in Section 104(c) applies to the allocation. This power may be exercised by a cotrustee in the circumstances described in Section 104(d) and may be released for the reasons and in the manner described in Section 104(e). An allocation is presumed to be insubstantial if:

(1) the amount of the allocation would increase or decrease net income in an accounting period, as determined before the allocation, by less than 10 percent; or

(2) the value of the asset producing the receipt for which the allocation would be made is less than 10 percent of the total value of the trust's assets at the beginning of the accounting period.

Comment

This section is intended to relieve a trustee from making relatively small allocations while preserving the trustee's right to do so if an allocation is large in terms of absolute dollars.

For example, assume that a trust's assets, which include a working interest in an oil well, have a value of $1,000,000; the net income from the assets other than the working interest is $40,000; and the net receipts from the working interest are $400. The trustee may allocate all of the net receipts from the working interest to principal instead of allocating 10%, or $40, to income under Section 411. If the net receipts from the working interest are $35,000, so that the amount allocated to income under Section 411 would be $3,500, the trustee may decide that this amount is sufficiently significant to the income beneficiary that the allocation provided for by Section 411 should be made, even though the trustee is still permitted under Section 408 to allocate all of the net receipts to principal because the $3,500 would increase the net income of $40,000, as determined before making an allocation under Section 411, by less than 10%. Section 408 will also relieve a trustee from having to allocate net receipts from the sale of trees in a small woodlot between principal and income.

While the allocation to principal of small amounts under this section should not be a cause for concern for tax purposes, allocations are not permitted under this section in circumstances described in Section 104(c) to eliminate claims that the power in this section has adverse tax consequences.

SECTION 409. DEFERRED COMPENSATION, ANNUITIES, AND SIMILAR PAYMENTS.

(a) In this section, "payment" means a payment that a trustee may receive over a fixed number of years or during the life of one or more individuals because of services rendered or property transferred to the payer in exchange for future payments. The term includes a payment made in money or property from the payer's general assets or from a separate fund created by the payer, including a private or commercial annuity, an individual retirement account, and a pension, profit-sharing, stock-bonus, or stock-ownership plan.

(b) To the extent that a payment is characterized as interest or a dividend or a payment made in lieu of interest or a dividend, a trustee shall allocate it to income. The trustee shall allocate to principal the balance of the payment and any other payment received in the same accounting period that is not characterized as interest, a dividend, or an equivalent payment.

(c) If no part of a payment is characterized as interest, a dividend, or an equivalent payment, and all or part of the payment is required to be made, a trustee shall allocate to income 10 percent of the part that is required to be made during the accounting period and the balance to principal. If no part of a payment is required to be made or the payment received is the entire amount to which the trustee is entitled, the trustee shall allocate the entire payment to principal. For purposes of this subsection, a payment is not "required to be made" to the extent that it is made because the trustee exercises a right of withdrawal.

(d) If, to obtain an estate tax marital deduction for a trust, a trustee must allocate more of a payment to income than provided for by this section, the trustee shall allocate to income the additional amount necessary to obtain the marital deduction.

(e) This section does not apply to payments to which Section 410 applies.

Comment

Scope. Section 409 applies to amounts received under contractual arrangements that provide for payments to a third party beneficiary as a result of services rendered or property transferred to the payer. While the right to receive such payments is a liquidating asset of the kind described in Section 410 (i.e., "an asset whose value will diminish or terminate because the asset is expected to produce receipts for a period of limited duration"), these payment rights are covered separately in Section 409 because of their special characteristics.

Section 409 applies to receipts from all forms of annuities and deferred compensation arrangements, whether the payment will be received by the trust in a lump sum or in installments over a period of years. It applies to bonuses that may be received over two or three years and payments that may last for much longer periods, including payments from an individual retirement account (IRA), deferred compensation plan (whether qualified or not qualified for special federal income tax treatment), and insurance renewal commissions. It applies to a retirement plan to which the settlor has made contributions, just as it applies to an annuity policy that the settlor may have purchased individually, and it applies to variable annuities, deferred annuities, annuities issued by commercial insurance companies, and "private annuities" arising from the sale of property to another individual or entity in exchange for payments that are to be made for the life of one or more individuals. The section applies whether the payments begin when the payment right becomes subject to the trust or are deferred until a future date, and it applies whether payments are made in cash or in kind, such as employer stock (in-kind payments usually will be made in a single distribution that will be allocated to principal under the second sentence of subsection (c)).

The 1962 Act. Under Section 12 of the 1962 Act, receipts from "rights to receive payments on a contract for deferred compensation" are allocated to income each year in an amount "not in excess of 5% per year" of the property's inventory value. While "not in excess of 5%" suggests that the annual allocation may range from zero to 5% of the inventory value, in practice the rule is usually treated as prescribing a 5% allocation. The inventory value is usually the present value of all the future payments, and since the inventory value is determined as of the date on which the payment right becomes subject to the trust, the inventory value, and thus the amount of the annual income allocation, depends significantly on the applicable interest rate on the decedent's date of death. That rate may be much higher or lower than the average long-term interest rate. The amount determined under the 5% formula tends to become fixed and remain unchanged even though the amount received by the trust increases or decreases.

Allocations Under Section 409(b). Section 409(b) applies to plans whose terms characterize payments made under the plan as dividends, interest, or payments in lieu of dividends or interest. For example, some deferred compensation plans that hold debt obligations or stock of the plan's sponsor in an account for future delivery to the person rendering the services provide for the annual payment to that person of dividends received on the stock or interest received on the debt obligations. Other plans provide that the account of the person rendering the services shall be credited with "phantom" shares of stock and require an annual payment that is equivalent to the dividends that would be received on that number of shares if they were actually issued; or a plan may entitle the person rendering the services to receive a fixed dollar amount in the future and provide for the annual payment of interest on the deferred amount during the period prior to its payment. Under Section 409(b), payments of dividends, interest or payments in lieu of dividends or interest under plans of this type are allocated to income; all other payments received under these plans are allocated to principal.

Section 409(b) does not apply to an IRA or an arrangement with payment provisions similar to an IRA. IRAs and similar arrangements are subject to the provisions in Section 409(c).

Allocations Under Section 409(c). The focus of Section 409, for purposes of allocating payments received by a trust to or between principal and income, is on the payment right rather than on assets that may be held in a fund from which the payments are made. Thus, if an IRA holds a portfolio of marketable stocks and bonds, the amount received by the IRA as dividends and interest is not taken into account in determining the principal and income allocation except to the extent that the Internal Revenue Service may require them to be taken into account when the payment is received by a trust that qualifies for the estate tax marital deduction (a situation that is provided for in Section 409(d)). An IRA is subject to federal income tax rules that require payments to begin by a particular date and be made over a specific number of years or a period measured by the lives of one or more persons. The payment right of a trust that is named as a beneficiary of an IRA is not a right to receive particular items that are paid to the IRA, but is instead the right to receive an amount determined by dividing the value of the IRA by the remaining number of years in the payment period. This payment right is similar to the right to receive a unitrust amount, which is normally expressed as an amount equal to a percentage of the value of the unitrust assets without regard to dividends or interest that may be received by the unitrust.

An amount received from an IRA or a plan with a payment provision similar to that of an IRA is allocated under Section 409(c), which differentiates between payments that are required to be made and all other payments. To the extent that a payment is required to be made (either under federal income tax rules or, in the case of a plan that is not subject to those rules, under the terms of the plan), 10% of the amount received is allocated to income and the balance is allocated to principal. All other payments are allocated to principal because they represent a change in the form of a principal asset; Section 409 follows the rule in Section 404(2), which provides that money or property received from a change in the form of a principal asset be allocated to principal.

Section 409(c) produces an allocation to income that is similar to the allocation under the 1962 Act formula if the annual payments are the same throughout the payment period, and it is simpler to administer. The amount allocated to income under Section 409 is not dependent upon the interest rate that is used for valuation purposes when the decedent dies, and if the payments received by the trust increase or decrease from year to year because the fund from which the payment is made increases or decreases in value, the amount allocated to income will also increase or decrease.

Marital deduction requirements. When an IRA is payable to a QTIP marital deduction trust, the IRS treats the IRA as separate terminable interest property and requires that a QTIP election be made for it. In order to qualify for QTIP treatment, an IRS ruling states that all of the IRA's income must be distributed annually to the QTIP marital deduction trust and then must be allocated to trust income for distribution to the spouse. Rev. Rul. 89-89, 1989-2 C.B. 231. If an allocation to income under this Act of 10% of the required distribution from the IRA does not meet the requirement that all of the IRA's income be distributed from the trust to the spouse, the provision in subsection (d) requires the trustee to make a larger allocation to income to the extent necessary to qualify for the marital deduction. The requirement of Rev. Rul. 89-89 should also be satisfied if the IRA beneficiary designation permits the spouse to require the trustee to withdraw the necessary amount from the IRA and distribute it to her, even though the spouse never actually requires the trustee to do so. If such a provision is in the beneficiary designation, a distribution under subsection (d) should not be necessary.

Application of Section 104. Section 104(a) of this Act gives a trustee who is acting under the prudent investor rule the power to adjust from principal to income if, considering the portfolio as a whole and not just receipts from deferred compensation, the trustee determines that an adjustment is necessary. See Example (5) in the Comment following Section 104.

SECTION 410. LIQUIDATING ASSET.

(a) In this section, "liquidating asset" means an asset whose value will diminish or terminate because the asset is expected to produce receipts for a period of limited duration. The term includes a leasehold, patent, copyright, royalty right, and right to receive payments during a period of more than one year under an arrangement that does not provide for the payment of interest on the unpaid balance. The term does not include a payment subject to Section 409, resources subject to Section 411, timber subject to Section 412, an activity subject to Section 414, an asset subject to Section 415, or any asset for which the trustee establishes a reserve for depreciation under Section 503.

(b) A trustee shall allocate to income 10 percent of the receipts from a liquidating asset and the balance to principal.

Comment

Prior Acts. Section 11 of the 1962 Act allocates receipts from "property subject to depletion" to income in an amount "not in excess of 5%" of the asset's inventory value. The 1931 Act has a similar 5% rule that applies when the trustee is under a duty to change the form of the investment. The 5% rule imposes on a trust the obligation to pay a fixed annuity to the income beneficiary until the asset is exhausted. Under both the 1931 and 1962 Acts the balance of each year's receipts is added to principal. A fixed payment can produce unfair results. The remainder beneficiary receives all of the receipts from unexpected growth in the asset, e.g., if royalties on a patent or copyright increase significantly. Conversely, if the receipts diminish more rapidly than expected, most of the amount received by the trust will be allocated to income and little to principal. Moreover, if the annual payments remain the same for the life of the asset, the amount allocated to principal will usually be less than the original inventory value. For these reasons, Section 410 abandons the annuity approach under the 5% rule.

Lottery payments. The reference in subsection (a) to rights to receive payments under an arrangement that does not provide for the payment of interest includes state lottery prizes and similar fixed amounts payable over time that are not deferred compensation arrangements covered by Section 409.

SECTION 411. MINERALS, WATER, AND OTHER NATURAL RESOURCES.

(a) To the extent that a trustee accounts for receipts from an interest in minerals or other natural resources pursuant to this section, the trustee shall allocate them as follows:

(1) If received as nominal delay rental or nominal annual rent on a lease, a receipt must be allocated to income.

(2) If received from a production payment, a receipt must be allocated to income if and to the extent that the agreement creating the production payment provides a factor for interest or its equivalent. The balance must be allocated to principal.

(3) If an amount received as a royalty, shut-in-well payment, take-or-pay payment, bonus, or delay rental is more than nominal, 90 percent must be allocated to principal and the balance to income.

(4) If an amount is received from a working interest or any other interest not provided for in paragraph (1), (2), or (3), 90 percent of the net amount received must be allocated to principal and the balance to income.

(b) An amount received on account of an interest in water that is renewable must be allocated to income. If the water is not renewable, 90 percent of the amount must be allocated to principal and the balance to income.

(c) This [Act] applies whether or not a decedent or donor was extracting minerals, water, or other natural resources before the interest became subject to the trust.

(d) If a trust owns an interest in minerals, water, or other natural resources on [the effective date of this [Act]], the trustee may allocate receipts from the interest as provided in this [Act] or in the manner used by the trustee before [the effective date of this [Act]]. If the trust acquires an interest in minerals, water, or other natural resources after [the effective date of this [Act]], the trustee shall allocate receipts from the interest as provided in this [Act].

Comment

Prior Acts. The 1962 Act allocates to principal as a depletion allowance, 27-1/2% of the gross receipts, but not more than 50% of the net receipts after paying expenses. The Internal Revenue Code no longer provides for a 27-1/2% depletion allowance, although the major oil-producing States have retained the 27-1/2% provision in their principal and income acts (Texas amended its Act in 1993, but did not change the depletion provision). Section 9 of the 1931 Act allocates all of the net proceeds received as consideration for the “permanent severance of natural resources from the lands” to principal.

Section 411 allocates 90% of the net receipts to principal and 10% to income. A depletion provision that is tied to past or present Code provisions is undesirable because it causes a large portion of the oil and gas receipts to be paid out as income. As wells are depleted, the amount received by the income beneficiary falls drastically. Allocating a larger portion of the receipts to principal enables the trustee to acquire other income producing assets that will continue to produce income when the mineral reserves are exhausted.

Application of Sections 403 and 408. This section applies to the extent that the trustee does not account separately for receipts from minerals and other natural resources under Section 403 or allocate all of the receipts to principal under Section 408.

Open mine doctrine. The purpose of Section 411(c) is to abolish the "open mine doctrine" as it may apply to the rights of an income beneficiary and a remainder beneficiary in receipts from the production of minerals from land owned or leased by a trust. Instead, such receipts are to be allocated to or between principal and income in accordance with the provisions of this Act. For a discussion of the open mine doctrine, see generally 3A Austin W. Scott & William F. Fratcher, The Law of Trusts § 239.3 (4th ed. 1988), and *Nutter v. Stockton*, 626 P.2d 861 (Okla. 1981).

Effective date provision. Section 9(b) of the 1962 Act provides that the natural resources provision does not apply to property interests held by the trust on the effective date of the Act, which reflects concerns about the constitutionality of applying a retroactive administrative provision to interests in real estate, based on the opinion in the Oklahoma case of *Franklin v. Margay Oil Corporation*, 153 P.2d 486, 501 (Okla. 1944). Section 411(d) permits a trustee to use either the method provided for in this Act or the method used before the Act takes effect. Lawyers in jurisdictions other than Oklahoma may conclude that retroactivity is not a problem as to property situated in their States, and this provision permits trustees to decide, based on advice from counsel in States whose law may be different from that of Oklahoma, whether they may apply this provision retroactively if they conclude that to do so is in the best interests of the beneficiaries.

If the property is in a State other than the State where the trust is administered, the trustee must be aware that the law of the property's situs may control this question. The outcome turns on a variety of questions: whether the terms of the trust specify that the law of a State other than the situs of the property shall govern the administration of the trust, and whether the courts will follow the terms of the trust; whether the trust's asset is the land itself or a leasehold interest in the land (as it frequently is with oil and gas property); whether a leasehold interest or its proceeds should be classified as real property or personal property, and if as personal property, whether applicable state law treats it as a movable or an immovable for conflict of laws purposes. See 5A Austin W. Scott & William F. Fratcher, The Law of Trusts §§ 648, at 531, 533-534; § 657, at 600 (4th ed. 1989).

SECTION 412. TIMBER.

(a) To the extent that a trustee accounts for receipts from the sale of timber and related products pursuant to this section, the trustee shall allocate the net receipts:

(1) to income to the extent that the amount of timber removed from the land does not exceed the rate of growth of the timber during the accounting periods in which a beneficiary has a mandatory income interest;

(2) to principal to the extent that the amount of timber removed from the land exceeds the rate of growth of the timber or the net receipts are from the sale of standing timber;

(3) to or between income and principal if the net receipts are from the lease of timberland or from a contract to cut timber from land owned by a trust, by determining the amount of timber removed from the land under the lease or contract and applying the rules in paragraphs (1) and (2); or

(4) to principal to the extent that advance payments, bonuses, and other payments are not allocated pursuant to paragraph (1), (2), or (3).

(b) In determining net receipts to be allocated pursuant to subsection (a), a trustee shall deduct and transfer to principal a reasonable amount for depletion.

(c) This [Act] applies whether or not a decedent or transferor was harvesting timber from the property before it become subject to the trust.

(d) If a trust owns an interest in timberland on [the effective date of this [Act]], the trustee may allocate net receipts from the sale of timber and related products as provided in this [Act] or in the manner used by the trustee before [the effective date of this [Act]]. If the trust acquires an interest in timberland after [the effective date of this [Act]], the trustee shall allocate net receipts from the sale of timber and related products as provided in this [Act].

Comment

Scope of section. The rules in Section 412 are intended to apply to net receipts from the sale of trees and by-products from harvesting and processing trees without regard to the kind of trees that are cut or whether the trees are cut before or after a particular number of years of growth. The rules apply to the sale of trees that are expected to produce lumber for building purposes, trees sold as pulpwood, and Christmas and other ornamental trees. Subsection (a) applies to net receipts from property owned by the trustee and property leased by the trustee. The Act is not intended to prevent a tenant in possession of the property from using wood that he cuts on the property for personal, noncommercial purposes, such as a Christmas tree, firewood, mending old fences or building new fences, or making repairs to structures on the property.

Under subsection (a), the amount of net receipts allocated to income depends upon whether the amount of timber removed is more or less than the rate of growth. The method of determining the amount of timber removed and the rate of growth is up to the trustee, based on methods customarily used for the kind of timber involved.

Application of Sections 403 and 408. This section applies to the extent that the trustee does not account separately for net receipts from the sale of timber and related products under Section 403 or allocate all of the receipts to principal under Section 408. The option to account for net receipts separately under Section 403 takes into consideration the possibility that timber harvesting operations may have been conducted before the timber property became subject to the trust, and that it may make sense to continue using accounting methods previously established for the property. It also permits a trustee to use customary accounting practices for timber operations even if no harvesting occurred on the property before it became subject to the trust.

SECTION 413. PROPERTY NOT PRODUCTIVE OF INCOME.

(a) If a marital deduction is allowed for all or part of a trust whose assets consist substantially of property that does not provide the surviving spouse with sufficient income from or use of the trust assets, and if the amounts that the trustee transfers from principal to income under Section 104 and distributes to the spouse from principal pursuant to the terms of the trust are insufficient to provide the spouse with the beneficial enjoyment required to obtain the marital deduction, the spouse may require the trustee to make property productive of income, convert property within a reasonable time, or exercise the power conferred by Section 104(a). The trustee may decide which action or combination of actions to take.

(b) In cases not governed by subsection (a), proceeds from the sale or other disposition of an asset are principal without regard to the amount of income the asset produces during any accounting period.

Comment

Prior Acts' Conflict with Uniform Prudent Investor Act. Section 2(b) of the Uniform Prudent Investor Act provides that "[a] trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole ... ." The underproductive property provisions in Section 12 of the 1962 Act and Section 11 of the 1931 Act give the income beneficiary a right to receive a portion of the proceeds from the sale of underproductive property as "delayed income." In each Act the provision applies on an asset by asset basis and not by taking into consideration the trust portfolio as a whole, which conflicts with the basic precept in Section 2(b) of the Prudent Investor Act. Moreover, in determining the amount of delayed income, the prior Acts do not permit a trustee to take into account the extent to which the trustee may have distributed principal to the income beneficiary, under principal invasion provisions in the terms of the trust, to compensate for insufficient income from the unproductive asset. Under Section 104(b)(7) of this Act, a trustee must consider prior distributions of principal to the income beneficiary in deciding whether and to what extent to exercise the power to adjust conferred by Section 104(a).

Duty to make property productive of income. In order to implement the Uniform Prudent Investor Act, this Act abolishes the right to receive delayed income from the sale proceeds of an asset that produces little or no income, but it does not alter existing state law regarding the income beneficiary's right to compel the trustee to make property productive of income. As the law continues to develop in this area, the duty to make property productive of current income in a particular situation should be determined by taking into consideration the performance of the portfolio as a whole and the extent to which a trustee makes principal distributions to the income beneficiary under the terms of the trust and adjustments between principal and income under Section 104 of this Act.

Trusts for which the value of the right to receive income is important for tax reasons may be affected by Reg. § 1.7520-3(b)(2)(v) *Example (1)*, § 20.7520-3(b)(2)(v) *Examples (1)* and *(2)*, and § 25.7520-3(b)(2)(v) *Examples (1)* and *(2)*, which provide that if the income beneficiary does not have the right to compel the trustee to make the property productive, the income interest is considered unproductive and may not be valued actuarially under those sections.

Marital deduction trusts. Subsection (a) draws on language in Reg. § 20.2056(b)-5(f)(4) and (5) to enable a trust for a surviving spouse to qualify for a marital deduction if applicable state law is unclear about the surviving spouse's right to compel the trustee to make property productive of income. The trustee should also consider the application of Section 104 of this Act and the provisions of Restatement of Trusts 3d: Prudent Investor Rule § 240, at 186, app. § 240, at 252 (1992). Example (6) in the Comment to Section 104 describes a situation involving the payment from income of carrying charges on unproductive real estate in which Section 104 may apply.

Once the two conditions have occurred – insufficient beneficial enjoyment from the property and the spouse's demand that the trustee take action under this section – the trustee must act; but instead of the formulaic approach of the 1962 Act, which is triggered only if the trustee sells the property, this Act permits the trustee to decide whether to make the property productive of income, convert it, transfer funds from principal to income, or to take some combination of those actions. The trustee may rely on the power conferred by Section 104(a) to adjust from principal to income if the trustee decides that it is not feasible or appropriate to make the property productive of income or to convert the property. Given the purpose of Section 413, the power under Section 104(a) would be exercised to transfer principal to income and not to transfer income to principal.

Section 413 does not apply to a so-called "estate" trust, which will qualify for the marital deduction, even though the income may be accumulated for a term of years or for the life of the surviving spouse, if the terms of the trust require the principal and undistributed income to be paid to the surviving spouse's estate when the spouse dies. Reg. § 20.2056(c)-2(b)(1)(iii).

SECTION 414. DERIVATIVES AND OPTIONS.

(a) In this section, "derivative" means a contract or financial instrument or a combination of contracts and financial instruments which gives a trust the right or obligation to participate in some or all changes in the price of a tangible or intangible asset or group of assets, or changes in a rate, an index of prices or rates, or other market indicator for an asset or a group of assets.

(b) To the extent that a trustee does not account under Section 403 for transactions in derivatives, the trustee shall allocate to principal receipts from and disbursements made in connection with those transactions.

(c) If a trustee grants an option to buy property from the trust, whether or not the trust owns the property when the option is granted, grants an option that permits another person to sell property to the trust, or acquires an option to buy property for the trust or an option to sell an asset owned by the trust, and the trustee or other owner of the asset is required to deliver the asset if the option is exercised, an amount received for granting the option must be allocated to principal. An amount paid to acquire the option must be paid from principal. A gain or loss realized upon the exercise of an option, including an option granted to a settlor of the trust for services rendered, must be allocated to principal.

Comment

Scope and application. It is difficult to predict how frequently and to what extent trustees will invest directly in derivative financial instruments rather than participating indirectly through investment entities that may utilize these instruments in varying degrees. If the trust participates in derivatives indirectly through an entity, an amount received from the entity will be allocated under Section 401 and not Section 414. If a trustee invests directly in derivatives to a significant extent, the expectation is that receipts and disbursements related to derivatives will be accounted for under Section 403; if a trustee chooses not to account under Section 403, Section 414(b) provides the default rule. Certain types of option transactions in which trustees may engage are dealt with in subsection (c) to distinguish those transactions from ones involving options that are embedded in derivative financial instruments.

Definition of "derivative." "Derivative" is a difficult term to define because new derivatives are invented daily as dealers tailor their terms to achieve specific financial objectives for particular clients. Since derivatives are typically contract-based, a derivative can probably be devised for almost any set of objectives if another party can be found who is willing to assume the obligations required to meet those objectives.

The most comprehensive definition of derivative is in the Exposure Draft of a Proposed Statement of Financial Accounting Standards titled "Accounting for Derivative and Similar Financial Instruments and for Hedging Activities," which was released by the Financial Accounting Standards Board (FASB) on June 20, 1996 (No. 162-B). The definition in Section 414(a) is derived in part from the FASB definition. The purpose of the definition in subsection (a) is to implement the substantive rule in subsection (b) that provides for all receipts and disbursements to be allocated to principal to the extent the trustee elects not to account for transactions in derivatives under Section 403. As a result, it is much shorter than the FASB definition, which serves much more ambitious objectives.

A derivative is frequently described as including futures, forwards, swaps and options, terms that also require definition, and the definition in this Act avoids these terms. FASB used the same approach, explaining in paragraph 65 of the Exposure Draft:

> The definition of *derivative financial instrument* in this Statement includes those financial instruments generally considered to be derivatives, such as forwards, futures, swaps, options, and similar instruments. The Board considered defining a derivative financial instrument by merely referencing those commonly understood instruments, similar to paragraph 5 of Statement 119, which says that "... a derivative financial instrument is a futures, forward, swap, or option contract, or other financial instrument with similar characteristics." However, the continued development of financial markets and innovative financial instruments could ultimately render a definition based on examples inadequate and obsolete. The Board, therefore, decided to base the definition of a derivative financial instrument on a description of the common characteristics of those instruments in order to accommodate the accounting for newly developed derivatives. (Footnote omitted.)

Marking to market. A gain or loss that occurs because the trustee marks securities to market or to another value during an accounting period is not a transaction in a derivative financial instrument that is income or principal under the Act – only cash receipts and disbursements, and the receipt of property in exchange for a principal asset, affect a trust's principal and income accounts.

Receipt of property other than cash. If a trustee receives property other than cash upon the settlement of a derivatives transaction, that property would be principal under Section 404(2).

Options. Options to which subsection (c) applies include an option to purchase real estate owned by the trustee and a put option purchased by a trustee to guard against a drop in value of a large block of marketable stock that must be liquidated to pay estate taxes. Subsection (c) would also apply to a continuing and regular practice of selling call options on securities owned by the trust if the terms of the option require delivery of the securities. It does not apply if the consideration received or given for the option is something other than cash or property, such as cross-options granted in a buy-sell agreement between owners of an entity.

SECTION 415. ASSET-BACKED SECURITIES.

(a) In this section, "asset-backed security" means an asset whose value is based upon the right it gives the owner to receive distributions from the proceeds of financial assets that provide collateral for the security. The term includes an asset that gives the owner the right to receive from the collateral financial assets only the interest or other current return or only the proceeds other than interest or current return. The term does not include an asset to which Section 401 or 409 applies.

(b) If a trust receives a payment from interest or other current return and from other proceeds of the collateral financial assets, the trustee shall allocate to income the portion of the payment which the payer identifies as being from interest or other current return and shall allocate the balance of the payment to principal.

(c) If a trust receives one or more payments in exchange for the trust's entire interest in an asset-backed security in one accounting period, the trustee shall allocate the payments to principal. If a payment is one of a series of payments that will result in the liquidation of the trust's interest in the security over more than one accounting period, the trustee shall allocate 10 percent of the payment to income and the balance to principal.

Comment

Scope of section. Typical asset-backed securities include arrangements in which debt obligations such as real estate mortgages, credit card receivables and auto loans are acquired by an investment trust and interests in the trust are sold to investors. The source for payments to an investor is the money received from principal and interest payments on the underlying debt. An asset-backed security includes an "interest only" or a "principal only" security that permits the investor to receive only the interest payments received from the bonds, mortgages or other assets that are the collateral for the asset-backed security, or only the principal payments made on those collateral assets. An asset-backed security also includes a security that permits the investor to participate in either the capital appreciation of an underlying security or in the interest or dividend return from such a security, such as the "Primes" and "Scores" issued by Americus Trust. An asset-backed security does not include an interest in a corporation, partnership, or an investment trust described in the Comment to Section 402, whose assets consist significantly or entirely of investment assets. Receipts from an instrument that do not come within the scope of this section or any other section of the Act would be allocated entirely to principal under the rule in Section 103(a)(4), and the trustee may then consider whether and to what extent to exercise the power to adjust in Section 104, taking into account the return from the portfolio as whole and other relevant factors.

[ARTICLE] 5
ALLOCATION OF DISBURSEMENTS DURING ADMINISTRATION OF TRUST

SECTION 501. DISBURSEMENTS FROM INCOME. A trustee shall make the following disbursements from income to the extent that they are not disbursements to which Section 201(2)(B) or (C) applies:

(1) one-half of the regular compensation of the trustee and of any person providing investment advisory or custodial services to the trustee;

(2) one-half of all expenses for accountings, judicial proceedings, or other matters that involve both the income and remainder interests;

(3) all of the other ordinary expenses incurred in connection with the administration, management, or preservation of trust property and the distribution of income, including interest, ordinary repairs, regularly recurring taxes assessed against principal, and expenses of a proceeding or other matter that concerns primarily the income interest; and

(4) recurring premiums on insurance covering the loss of a principal asset or the loss of income from or use of the asset.

Comment

Trustee fees. The regular compensation of a trustee or the trustee's agent includes compensation based on a percentage of either principal or income or both.

Insurance premiums. The reference in paragraph (4) to "recurring" premiums is intended to distinguish premiums paid annually for fire insurance from premiums on title insurance, each of which covers the loss of a principal asset. Title insurance premiums would be a principal disbursement under Section 502(a)(5).

Regularly recurring taxes. The reference to "regularly recurring taxes assessed against principal" includes all taxes regularly imposed on real property and tangible and intangible personal property.

SECTION 502. DISBURSEMENTS FROM PRINCIPAL.

(a) A trustee shall make the following disbursements from principal:

(1) the remaining one-half of the disbursements described in Section 501(1) and (2);

(2) all of the trustee's compensation calculated on principal as a fee for acceptance, distribution, or termination, and disbursements made to prepare property for sale;

(3) payments on the principal of a trust debt;

(4) expenses of a proceeding that concerns primarily principal, including a proceeding to construe the trust or to protect the trust or its property;

(5) premiums paid on a policy of insurance not described in Section 501(4) of which the trust is the owner and beneficiary;

(6) estate, inheritance, and other transfer taxes, including penalties, apportioned to the trust; and

(7) disbursements related to environmental matters, including reclamation, assessing environmental conditions, remedying and removing environmental contamination, monitoring remedial activities and the release of substances, preventing future releases of substances, collecting amounts from persons liable or potentially liable

for the costs of those activities, penalties imposed under environmental laws or regulations and other payments made to comply with those laws or regulations, statutory or common law claims by third parties, and defending claims based on environmental matters.

(b) If a principal asset is encumbered with an obligation that requires income from that asset to be paid directly to the creditor, the trustee shall transfer from principal to income an amount equal to the income paid to the creditor in reduction of the principal balance of the obligation.

Comment

Environmental expenses. All environmental expenses are payable from principal, subject to the power of the trustee to transfer funds to principal from income under Section 504. However, the Drafting Committee decided that it was not necessary to broaden this provision to cover other expenditures made under compulsion of governmental authority. See generally the annotation at 43 A.L.R.4th 1012 (Duty as Between Life Tenant and Remainderman with Respect to Cost of Improvements or Repairs Made Under Compulsion of Governmental Authority).

Environmental expenses paid by a trust are to be paid from principal under Section 502(a)(7) on the assumption that they will usually be extraordinary in nature. Environmental expenses might be paid from income if the trustee is carrying on a business that uses or sells toxic substances, in which case environmental cleanup costs would be a normal cost of doing business and would be accounted for under Section 403. In accounting under that Section, environmental costs will be a factor in determining how much of the net receipts from the business is trust income. Paying all other environmental expenses from principal is consistent with this Act's approach regarding receipts – when a receipt is not clearly a current return on a principal asset, it should be added to principal because over time both the income and remainder beneficiaries benefit from this treatment. Here, allocating payments required by environmental laws to principal imposes the detriment of those payments over time on both the income and remainder beneficiaries.

Under Sections 504(a) and 504(b)(5), a trustee who makes or expects to make a principal disbursement for an environmental expense described in Section 502(a)(7) is authorized to transfer an appropriate amount from income to principal to reimburse principal for disbursements made or to provide a reserve for future principal disbursements.

The first part of Section 502(a)(7) is based upon the definition of an "environmental remediation trust" in Treas. Reg. § 301.7701-4(e)(as amended in 1996). This is not because the Act applies to an environmental remediation trust, but because the definition is a useful and thoroughly vetted description of the kinds of expenses that a trustee owning contaminated property might incur. Expenses incurred to comply with environmental laws include the cost of environmental consultants, administrative proceedings and burdens of every kind imposed as the result of an administrative or judicial proceeding, even though the burden is not formally characterized as a penalty.

Title proceedings. Disbursements that are made to protect a trust's property, referred to in Section 502(a)(4), include an "action to assure title" that is mentioned in Section 13(c)(2) of the 1962 Act.

Insurance premiums. Insurance premiums referred to in Section 502(a)(5) include title insurance premiums. They also include premiums on life insurance policies owned by the trust, which represent the trust's periodic investment in the insurance policy. There is no provision in the 1962 Act for life insurance premiums.

Taxes. Generation-skipping transfer taxes are payable from principal under subsection (a)(6).

SECTION 503. TRANSFERS FROM INCOME TO PRINCIPAL FOR DEPRECIATION.

(a) In this section, "depreciation" means a reduction in value due to wear, tear, decay, corrosion, or gradual obsolescence of a fixed asset having a useful life of more than one year.

(b) A trustee may transfer to principal a reasonable amount of the net cash receipts from a principal asset that is subject to depreciation, but may not transfer any amount for depreciation:

(1) of that portion of real property used or available for use by a beneficiary as a residence or of tangible personal property held or made available for the personal use or enjoyment of a beneficiary;

(2) during the administration of a decedent's estate; or

(3) under this section if the trustee is accounting under Section 403 for the business or activity in which the asset is used.

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

Comment

Prior Acts. The 1931 Act has no provision for depreciation. Section 13(a)(2) of the 1962 Act provides that a charge shall be made against income for "... a reasonable allowance for depreciation on property subject to depreciation under generally accepted accounting principles ... ." That provision has been resisted by many trustees, who do not provide for any depreciation for a variety of reasons. One reason relied upon is that a charge for depreciation is not needed to protect the remainder beneficiaries if the value of the land is increasing; another is that generally accepted accounting principles may not require depreciation to be taken if the property is not part of a business. The Drafting Committee concluded that the decision to provide for depreciation should be discretionary with the trustee. The power to transfer funds from income to principal that is granted by this section is a discretionary power of administration referred to in Section 103(b), and in exercising the power a trustee must comply with Section 103(b).

One purpose served by transferring cash from income to principal for depreciation is to provide funds to pay the principal of an indebtedness secured by the depreciable property. Section 504(b)(4) permits the trustee to transfer additional cash from income to principal for this purpose to the extent that the amount transferred from income to principal for depreciation is less than the amount of the principal payments.

SECTION 504. TRANSFERS FROM INCOME TO REIMBURSE PRINCIPAL.

(a) If a trustee makes or expects to make a principal disbursement described in this section, the trustee may transfer an appropriate amount from income to principal in one or more accounting periods to reimburse principal or to provide a reserve for future principal disbursements.

(b) Principal disbursements to which subsection (a) applies include the following, but only to the extent that the trustee has not been and does not expect to be reimbursed by a third party:

(1) an amount chargeable to income but paid from principal because it is unusually large, including extraordinary repairs;

(2) a capital improvement to a principal asset, whether in the form of changes to an existing asset or the construction of a new asset, including special assessments;

(3) disbursements made to prepare property for rental, including tenant allowances, leasehold improvements, and broker's commissions;

(4) periodic payments on an obligation secured by a principal asset to the extent that the amount transferred from income to principal for depreciation is less than the periodic payments; and

(5) disbursements described in Section 502(a)(7).

(c) If the asset whose ownership gives rise to the disbursements becomes subject to a successive income interest after an income interest ends, a trustee may continue to transfer amounts from income to principal as provided in subsection (a).

Comment

Prior Acts. The sources of Section 504 are Section 13(b) of the 1962 Act, which permits a trustee to "regularize distributions," if charges against income are unusually large, by using "reserves or other reasonable means" to withhold sums from income distributions; Section 13(c)(3) of the 1962 Act, which authorizes a trustee to establish an allowance for depreciation out of income if principal is used for extraordinary repairs, capital improvements and special assessments; and Section 12(3) of the 1931 Act, which permits the trustee to spread income expenses of unusual amount "throughout a series of years." Section 504 contains a more detailed enumeration of the circumstances in which this authority may be used, and includes in subsection (b)(4) the express authority to use income to make principal payments on a mortgage if the depreciation charge against income is less than the principal payments on the mortgage.

SECTION 505. INCOME TAXES.

(a) A tax required to be paid by a trustee based on receipts allocated to income must be paid from income.

(b) A tax required to be paid by a trustee based on receipts allocated to principal must be paid from principal, even if the tax is called an income tax by the taxing authority.

(c) A tax required to be paid by a trustee on the trust's share of an entity's taxable income must be paid proportionately:

(1) from income to the extent that receipts from the entity are allocated to income; and

(2) from principal to the extent that:

(A) receipts from the entity are allocated to principal; and

(B) the trust's share of the entity's taxable income exceeds the total receipts described in paragraphs (1) and (2)(A).

(d) For purposes of this section, receipts allocated to principal or income must be reduced by the amount distributed to a beneficiary from principal or income for which the trust receives a deduction in calculating the tax.

Comment

Electing Small Business Trusts. An Electing Small Business Trust (ESBT) is a creature created by Congress in the Small Business Job Protection Act of 1996 (P.L. 104-188). For years beginning after 1996, an ESBT may qualify as an S corporation stockholder even if the trustee does not distribute all of the trust's income annually to its beneficiaries. The portion of an ESBT that consists of the S corporation stock is treated as a separate trust for tax purposes (but not for trust accounting purposes), and the S corporation income is taxed directly to that portion of the trust even if some or all of that income is distributed to the beneficiaries.

A trust normally receives a deduction for distributions it makes to its beneficiaries. Subsection (d) takes into account the possibility that an ESBT may not receive a deduction for trust accounting income that is distributed to the beneficiaries. Only limited guidance has been issued by the Internal Revenue Service, and it is too early to anticipate all of the technical questions that may arise, but the powers granted to a trustee in Sections 506 and 104 to make adjustments are probably sufficient to enable a trustee to correct inequities that may arise because of technical problems.

SECTION 506. ADJUSTMENTS BETWEEN PRINCIPAL AND INCOME BECAUSE OF TAXES.

(a) A fiduciary may make adjustments between principal and income to offset the shifting of economic interests or tax benefits between income beneficiaries and remainder beneficiaries which arise from:

(1) elections and decisions, other than those described in subsection (b), that the fiduciary makes from time to time regarding tax matters;

(2) an income tax or any other tax that is imposed upon the fiduciary or a beneficiary as a result of a transaction involving or a distribution from the estate or trust; or

(3) the ownership by an estate or trust of an interest in an entity whose taxable income, whether or not distributed, is includable in the taxable income of the estate, trust, or a beneficiary.

(b) If the amount of an estate tax marital deduction or charitable contribution deduction is reduced because a fiduciary deducts an amount paid from principal for income tax purposes instead of deducting it for estate tax purposes, and as a result estate taxes paid from principal are increased and income taxes paid by an estate, trust, or beneficiary are decreased, each estate, trust, or beneficiary that benefits from the decrease in income tax shall reimburse the principal from which the increase in estate tax is paid. The total reimbursement must equal the increase in the estate tax to the extent that the principal used to pay the increase would have qualified for a marital deduction or charitable contribution deduction but for the payment. The proportionate share of the reimbursement for each estate, trust, or beneficiary whose income taxes are reduced must be the same as its proportionate share of the total decrease in income tax. An estate or trust shall reimburse principal from income.

Comment

Discretionary adjustments. Section 506(a) permits the fiduciary to make adjustments between income and principal because of tax law provisions. It would permit discretionary adjustments in situations like these: (1) A fiduciary elects to deduct administration expenses that are paid from principal on an income tax return instead of on the estate tax return; (2) a distribution of a principal asset to a trust or other beneficiary causes the taxable income of an estate or trust to be carried out to the distributee and relieves the persons who receive the income of any obligation to pay income tax on the income; or (3) a trustee realizes a capital gain on the sale of a principal asset and pays a large state income tax on the gain, but under applicable federal income tax rules the trustee may not deduct the state income tax payment from the capital gain in calculating the trust's federal capital gain tax, and the income beneficiary receives the benefit of the deduction for state income tax paid on the capital gain. See generally Joel C. Dobris, Limits on the Doctrine of Equitable Adjustment in Sophisticated Postmortem Tax Planning, 66 Iowa L. Rev. 273 (1981).

Section 506(a)(3) applies to a qualified Subchapter S trust (QSST) whose income beneficiary is required to include a pro rata share of the S corporation's taxable income in his return. If the QSST does not receive a cash distribution from the corporation that is large enough to cover the income beneficiary's tax liability, the trustee may distribute additional cash from principal to the income beneficiary. In this case the retention of cash by the corporation benefits the trust principal. This situation could occur if the corporation's taxable income includes capital gain from the sale of a business asset and the sale proceeds are reinvested in the business instead of being distributed to shareholders.

Mandatory adjustment. Subsection (b) provides for a mandatory adjustment from income to principal to the extent needed to preserve an estate tax marital deduction or charitable contributions deduction. It is derived from New York's EPTL § 11-1.2(A), which requires principal to be reimbursed by those who benefit when a fiduciary elects to deduct administration expenses on an income tax return instead of the estate tax return. Unlike the New York provision, subsection (b) limits a mandatory reimbursement to cases in which a marital deduction or a charitable contributions deduction is reduced by the payment of additional estate taxes because of the fiduciary's income tax election. It is intended to preserve the result reached in *Estate of Britenstool v. Commissioner*, 46 T.C. 711 (1966), in which the Tax Court held that a reimbursement required by the predecessor of EPTL § 11-1.2(A) resulted in the estate receiving the same charitable contributions deduction it would have received if the administration expenses had been deducted for estate tax purposes instead of for income tax purposes. Because a fiduciary will elect to deduct administration expenses for income tax purposes only when the income tax reduction exceeds the estate tax reduction, the effect of this adjustment is that the principal is placed in the same position it would have occupied if the fiduciary had deducted the expenses for estate tax purposes, but the income beneficiaries receive an additional benefit. For example, if the income tax benefit from the deduction is $30,000 and the estate tax benefit would have been $20,000, principal will be reimbursed $20,000 and the net benefit to the income beneficiaries will be $10,000.

Irrevocable grantor trusts. Under Sections 671-679 of the Internal Revenue Code (the “grantor trust” provisions), a person who creates an irrevocable trust for the benefit of another person may be subject to tax on the trust’s income or capital gains, or both, even though the settlor is not entitled to receive any income or principal from the trust. Because this is now a well-known tax result, many trusts have been created to produce this result, but there are also trusts that are unintentionally subject to this rule. The Act does not require or authorize a trustee to distribute funds from the trust to the settlor in these cases because it is difficult to establish a rule that applies only to trusts where this tax result is unintended and does not apply to trusts where the tax result is intended. Settlors who intend this tax result rarely state it as an objective in the terms of the trust, but instead rely on the operation of the tax law to produce the desired result. As a result it may not be possible to determine from the terms of the trust if the result was intentional or unintentional. If the drafter of such a trust wants the trustee to have the authority to distribute principal or income to the settlor to reimburse the settlor for taxes paid on the trust’s income or capital gains, such a provision should be placed in the terms of the trust. In some situations the Internal Revenue Service may require that such a provision be placed in the terms of the trust as a condition to issuing a private letter ruling.

[ARTICLE] 6
MISCELLANEOUS PROVISIONS

SECTION 601. UNIFORMITY OF APPLICATION AND CONSTRUCTION. In applying and construing this Uniform Act, consideration must be given to the need to promote uniformity of the law with respect to its subject matter among States that enact it.

SECTION 602. SEVERABILITY CLAUSE. If any provision of this [Act] or its application to any person or circumstance is held invalid, the invalidity does not affect other provisions or applications of this [Act] which can be given effect without the invalid provision or application, and to this end the provisions of this [Act] are severable.

SECTION 603. REPEAL. The following acts and parts of acts are repealed:

(1) ....

(2) ....

(3) ....

SECTION 604. EFFECTIVE DATE. This [Act] takes effect on ....

SECTION 605. APPLICATION OF [ACT] TO EXISTING TRUSTS AND ESTATES. This [Act] applies to every trust or decedent's estate existing on [the effective date of this [Act]] except as otherwise expressly provided in the will or terms of the trust or in this [Act].

STATE OF CALIFORNIA

CALIFORNIA LAW REVISION COMMISSION

STAFF REPORT

California Uniform Prudent Investor Act

March 1998

California Law Revision Commission
4000 Middlefield Road, Room D-1
Palo Alto, CA 94303-4739

NOTE

This is a special edition of the Uniform Prudent Investor Act setting out the original explanatory text from the Commission's recommendation and the final statutory text with official Commission Comments.

UNIFORM PRUDENT INVESTOR ACT *

A new Uniform Prudent Investor Act was approved by the National Conference of Commissioners on Uniform State Laws in the summer of 1994.[1] The new act seeks to modernize investment practices of fiduciaries, focusing on trustees of private trusts.

The primary objectives of the UPIA are stated in its Prefatory Note:

> (1) The standard of prudence is applied to any investment as part of the total portfolio, rather than to individual investments. In the trust setting the term "portfolio" embraces all the trust's assets.…
>
> (2) The tradeoff in all investing between risk and return is identified as the fiduciary's central consideration.…
>
> (3) All categoric restrictions on types of investments have been abrogated; the trustee can invest in anything that plays an appropriate role in achieving the risk/return objectives of the trust and that meets the other requirements of prudent investing.…
>
> (4) The long familiar requirement that fiduciaries diversify their investments has been integrated into the definition of prudent investing.…
>
> (5) The much criticized former rule of trust law forbidding the trustee to delegate investment and management functions has been reversed. Delegation is now permitted, subject to safeguards.…

Some of these objectives have already been met in existing California law. California adopted a portfolio approach to investments by trustees in 1984,[2] and early recognized the trustee's power to make any type of investment in conformance with applicable duties.[3] While preserving the traditional rule against delegating administration of the trust to others, existing law recognizes the ability of trustees to make limited delegations where appropriate and to hire experts to assist in

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* This "Staff Report" combines the text of the original Commission recommendation on the *Uniform Prudent Investor Act*, 25 Cal. L. Revision Comm'n Reports 543, 549-552 (1995), with the text of the statute as enacted (1995 Cal. Stat. ch. 63) and revised Comments printed in the *Report of the California Law Revision Commission on Chapter 63 of the Statutes of 1995 (Senate Bill 222)*, in Appendix 4 of the*Annual Report for 1995*, 25 Cal. L. Revision Comm'n Reports 615, 673-705 (1995). No words have been changed, but revised Comments to Probate Code Sections 16200 and 16223, which were included in Appendix 4, have been omitted because they were superseded.

1. The official text of the Uniform Prudent Investor Act [hereinafter "UPIA" or the "uniform act"] is set out as an Appendix, *infra* at pp. 589-613. The uniform act relies heavily on the revised standards for prudent trust investments promulgated in the new Restatement (Third) of Trusts: Prudent Investor Rule (1992).

2. See Prob. Code § 16040(b) & Comment; see also *Selected 1986 Trust and Probate Legislation,* 18 Cal. L. Revision Comm'n Reports 1201, 1240-42 (1986).

3. See Prob. Code § 16223 & Comment. This rule was adopted from the Uniform Trustees' Powers Act (1964).

administration of the trust.[4] The duty to diversify has not been codified, but is recognized in case law.[5]

Adoption of the Uniform Prudent Investor Act would add several new features to the Trust Law:

Risk. The law would specifically recognize the importance of analyzing both risk and return, consistent with modern investment theory. Rather than avoiding risk categorically, the uniform act encourages balancing risk and return at levels appropriate to the purposes of the trust.[6] This rule is not inconsistent with existing law,[7] but provides greater detail as to the factors to be considered in devising the portfolio investment strategy.

Delegation. A trustee would be able to delegate investment and management decisions where prudent in light of the trustee's skills.[8] The trustee must exercise care, skill, and caution in selecting the agent and establishing the scope and terms of the delegation consistent with the purposes and terms of the trust, and must monitor the agent's performance.

Trustee's liability for delegation. A trustee who satisfies the delegation standards would not be liable to the beneficiaries for the acts of an agent.[9] This rule is more protective of trustees who make a proper delegation than the existing standard which, among other things, subjects a trustee for liability if the trustee has the power to direct the act of the agent.[10]

Liability of agent. An agent who performs a delegated function owes a duty to the trust and, by accepting the delegation, would be deemed to submit to the jurisdiction of California courts.[11]

Standard of compliance. "Compliance with the prudent investment rule is determined in light of the facts and circumstances existing at the time of a trustee's decision or action and not by hindsight."[12] This rule emphasizes and protects reliance on the fundamental rule of prudence in adopting an investment strategy and managing the trust. It is consistent with the principle in existing law protecting

4. See Prob. Code §§ 16012 (general duty not to delegate), 16247 (hiring accountants, investment advisors, etc.).

5. See, e.g., Estate of Collins, 72 Cal. App. 3d 663, 669-72, 139 Cal. Rptr. 644, 648-49 (1977).

6. See UPIA § 2 & comment.

7. See Prob. Code § 16040(b).

8. See UPIA § 9 & comment.

9. See UPIA § 9(c) & comment.

10. See Prob. Code § 16401(b)(1). This rule should be changed for consistency with UPIA and with the Restatement (Second) of Trusts § 225 (1957). Consequently, the exception where the trustee has the "power to direct" the agent would be revised to refer to cases where the trustee "directs or permits" the acts of the agent.

11. See UPIA § 9(b) & (d).

12. UPIA § 8.

a trustee who has acted "reasonably and in good faith under the circumstances as known to the trustee."[13]

Application to existing trusts. The prudent investor rule would apply to existing trusts but not to decisions or actions occurring before it became operative.[14] The same general principle was applied when the Trust Law became operative.[15]

13. Prob. Code § 16440(b).

14. See UPIA § 16.

15. See Prob. Code § 15001 & Comment; see also Prob. Code § 3.

CONTENTS

Prob. Code §§ 16045-16054 (added). Uniform Prudent Investor Act

SEC. 6. Article 2.5 (commencing with Section 16045) is added to Chapter 1 of Part 4 of Division 9 of the Probate Code, to read:

Article 2.5. Uniform Prudent Investor Act

§ 16045. Short title

16045. This article, together with subdivision (a) of Section 16002 and Section 16003, constitutes the prudent investor rule and may be cited as the Uniform Prudent Investor Act.

Comment. Section 16045 has the same purpose as Section 12 of the Uniform Prudent Investor Act (1994) promulgated by the National Conference of Commissioners on Uniform State Laws. Most of the substance of the uniform act is set forth in this article, but some rules already exist in other parts of the Trust Law and are included within the short title by specific reference. See Sections 16002(a) (duty of loyalty), 16003 (duty to deal impartially with beneficiaries).

See also Section 2 (construction of provisions drawn from uniform acts), which is the same in substance as Section 11 of the Uniform Prudent Investor Act (1994), and Section 13 (severability), which is the same in substance as Section 14 of the Uniform Prudent Investor Act (1994). For a list of uniform acts in the Probate Code, see Section 2 Comment.

§ 16046. Prudent investor rule

16046. (a) Except as provided in subdivision (b), a trustee who invests and manages trust assets owes a duty to the beneficiaries of the trust to comply with the prudent investor rule.

(b) The settlor may expand or restrict the prudent investor rule by express provisions in the trust instrument. A trustee is not liable to a beneficiary for the trustee's good faith reliance on these express provisions.

Comment. Section 16046 is similar to Section 1 of the Uniform Prudent Investor Act (1994). See also Section 16045 (prudent investor rule defined). Subdivision (a) and the first sentence of subdivision (b) are a special application of the general duty provided in Section 16000 (duty to administer trust according to statute, subject to control in trust).

Subdivision (b) continues the rule in former subdivision (c) (now subdivision (b)) of Section 16040, insofar as it applied to matters now governed by this article. The first sentence of subdivision (b) is the same in substance as the first sentence Section 1(b) of the Uniform Prudent Investor Act (1994). The second sentence continues the good-faith standard of Section 16040 in place of the reasonable reliance rule of the Uniform Prudent Investor Act (1994).

§ 16047. Standard of care, portfolio strategy, risk and return objectives

16047. (a) A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.

(b) A trustee's investment and management decisions respecting individual assets and courses of action must be evaluated not in isolation, but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust.

(c) Among circumstances that are appropriate to consider in investing and managing trust assets are the following, to the extent relevant to the trust or its beneficiaries:

(1) General economic conditions.

(2) The possible effect of inflation or deflation.

(3) The expected tax consequences of investment decisions or strategies.

(4) The role that each investment or course of action plays within the overall trust portfolio.

(5) The expected total return from income and the appreciation of capital.

(6) Other resources of the beneficiaries known to the trustee as determined from information provided by the beneficiaries.

(7) Needs for liquidity, regularity of income, and preservation or appreciation of capital.

(8) An asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.

(d) A trustee shall make a reasonable effort to ascertain facts relevant to the investment and management of trust assets.

(e) A trustee may invest in any kind of property or type of investment or engage in any course of action or investment strategy consistent with the standards of this chapter.

Comment. Section 16047 is generally the same in substance as Section 2(a)-(e) of the Uniform Prudent Investor Act (1994). Subdivisions (a)-(c) of Section 16047 replace the portfolio investment rule of former subdivision (b) of Section 16040. Subdivision (a) is also the same in substance as the first paragraph and subsection (a) of Section 227 of Restatement (Third) of Trusts: Prudent Investor Rule (1992).

The second sentence of subdivision (a) states the basic elements of prudence. Thus, where "prudence" is used in this article, it includes "reasonable care, skill, and caution." These elements are delineated in the Restatement:

> *[Care]*
>
> The duty of care requires the trustee to exercise reasonable effort and diligence in making and monitoring investments for the trust, with attention to the trust's objectives. The trustee has a related duty of care in keeping informed of rights and opportunities associated with those investments.…
>
> *[Skill]*
>
> The exercise of care alone is not sufficient, however, because a trustee is liable for losses resulting from failure to use the skill of an individual of ordinary intelligence. This is so despite the careful use of all the skill of which the particular trustee is capable.
>
> On the other hand, if follows from the requirement of care as well as from sound policy that, if the trustee possesses a degree of skill greater than that of an individual of ordinary intelligence, the trustee is liable for a loss that results from failure to make reasonably diligent use of that skill.…
>
> *[Caution]*
>
> In addition to the duty to use care and skill, the trustee must exercise the caution of a prudent investor managing similar funds for similar purposes. In the absence of contrary provisions in the terms of the trust, this requirement of caution requires the trustee to invest with a view both to safety of the capital and to securing a reasonable return.…

Restatement (Third) of Trusts: Prudent Investor Rule § 227 comments d & e (1992). For a full discussion, see *id.* § 227, comments & Reporter's Notes (1992).

Subdivision (d) is new to the code. Subdivision (e) replaces former Section 16223 ("The trustee has the power to invest in any kind of property, whether real, personal, or mixed."). This subdivision, like its predecessor, makes clear that there are no categorical restrictions on proper investments. Any form of investment is permissible in the absence of a prohibition in the trust instrument or an overriding duty. This subdivision is intended to permit investment in investment company shares, mutual funds, index funds, and other modern vehicles for collective investments. While investment in these funds is not forbidden merely because discretion over the fund is delegated to others, the trustee is ultimately subject to fiduciary standards under this chapter in making the investment. See also Sections 62 ("property" defined), 16053 (language invoking standard of Uniform Prudent Investor Act), 16202 (exercise of powers is subject to duties), 16203 (trust instrument that incorporates the powers provided in former Section 1120.2 of the repealed Probate Code).

Statutes pertaining to legal investments appear in other codes. See, e.g., Fin. Code §§ 1561.1 (funds provided services by trust company or affiliate), 1564 (common trust funds); Gov't Code §§ 971.2, 17202, 61673; Harb. & Nav. Code §§ 6331, 6931; Health & Safety Code §§ 33663, 34369, 37649, 52040, 52053.5; Pub. Res. Code § 26026; Sts. & Hy. Code §§ 8210, 25371, 30241, 30242, 31173; Water Code §§ 9526, 20064.

Section 2(f) of the Uniform Prudent Investor Act (1994) has been omitted from Section 16047 because it is unnecessary. The same general rule is provided by Section 16014 (duty to use special skills). An expert trustee is held to the standard of care of other experts. See the discussions in Estate of Collins, 72 Cal. App. 3d 663, 673, 139 Cal. Rptr. 644 (1977); Coberly v. Superior Court, 231 Cal. App. 2d 685, 689, 42 Cal. Rptr. 64 (1965); Estate of Beach, 15 Cal. 3d 623, 635, 542 P.2d 994, 125 Cal. Rptr. 570 (1975) (bank as executor); see also Section 2401 Comment (standard of care applicable to professional guardian or conservator of estate); Section 3912 Comment (standard of care applicable to professional fiduciary acting as custodian under California Uniform Transfers to Minors Act).

§ 16048. Diversification

16048. In making and implementing investment decisions, the trustee has a duty to diversify the investments of the trust unless, under the circumstances, it is prudent not to do so.

Comment. Section 16048 is drawn from Section 227(b) of the Restatement (Third) of Trusts: Prudent Investor Rule (1992), and is similar to Section 3 of the Uniform Prudent Investor Act (1994). This section is new to the Trust Law, but is consistent with case law. See, e.g., Estate of Collins, 72 Cal. App. 3d 663, 669-72, 139 Cal. Rptr. 644, 648-49 (1977). This section, along with Section 16049, supersedes the rule in former Section 16008 (disposition of improper investments and retention of property in furtherance of trust purposes). See the comments to Restatement (Third) of Trusts: Prudent Investor Rule § 227 (1992).

§ 16049. Duties at inception of trusteeship

16049. Within a reasonable time after accepting a trusteeship or receiving trust assets, a trustee shall review the trust assets and make and implement decisions concerning the retention and disposition of assets, in order to bring the trust portfolio into compliance with the purposes, terms, distribution requirements, and other circumstances of the trust, and with the requirements of this chapter.

Comment. Section 16049 is the same as Section 4 of the Uniform Prudent Investor Act (1994). For related duties, see Sections 16000 (duty to administer trust on acceptance), 16006 (duty to take control of and preserve trust property). This section, along with Section 16048, supersedes the rule in former Section 16008 (disposition of improper investments and retention of property in furtherance of trust purposes).

§ 16050. Investment costs

16050. In investing and managing trust assets, a trustee may only incur costs that are appropriate and reasonable in relation to the assets, overall investment strategy, purposes, and other circumstances of the trust.

Comment. Section 16050 is similar to Section 7 of the Uniform Prudent Investor Act (1994). This section is consistent with the rules concerning costs in Section 227(c)(3) of the Restatement (Third) of Trusts: Prudent Investor Rule (1992). For related rules concerning reimbursement and compensation of trustees, see Sections 15680-15685. The duty to minimize costs applies to delegation to agents and hiring advisers as well as to other aspects of fiduciary investing. In deciding whether to delegate, the trustee must balance the projected benefits against the likely costs. Similarly, in deciding how to delegate, the trustee must take costs into account. The trustee must be alert to protect the beneficiary from "double dipping." If, for example, the trustee's regular compensation schedule presupposes that the trustee will conduct the investment management function, it should ordinarily follow that the trustee will lower its fee if delegating the investment function to an outside manager.

§ 16051. Reviewing compliance

16051. Compliance with the prudent investor rule is determined in light of the facts and circumstances existing at the time of a trustee's decision or action and not by hindsight.

Comment. Section 16051 is the same as Section 8 of the Uniform Prudent Investor Act (1994). See also Section 16045 (prudent investor rule defined). For related rules governing trustee liability, see Sections 16440-16465.

§ 16052. Delegation of investment and management functions

16052. (a) A trustee may delegate investment and management functions as prudent under the circumstances. The trustee shall exercise prudence in the following:

(1) Selecting an agent.

(2) Establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust.

(3) Periodically reviewing the agent's overall performance and compliance with the terms of the delegation.

(b) In performing a delegated function, an agent has a duty to exercise reasonable care to comply with the terms of the delegation.

(c) Except as otherwise provided in Section 16401, a trustee who complies with the requirements of subdivision (a) is not liable to the beneficiaries or to the trust for the decisions or actions of the agent to whom the function was delegated.

(d) By accepting the delegation of a trust function from the trustee of a trust that is subject to the law of this state, an agent submits to the jurisdiction of the courts of this state.

Comment. Section 16052 is the same in substance as Section 9 of the Uniform Prudent Investor Act (1994), except that subdivision (c) has been revised for coordination with the basic rule on liability for acts of agents in Section 16401. Unlike the uniform act, the second sentence of subdivision (a) refers to the exercise of "prudence" rather than "reasonable care, skill, and caution." This is not a substantive change, however, since "prudence" means "reasonable care, skill, and caution" as provided in Section 16047(a). See Section 16047 Comment.

The duty to review the agent's overall performance under subdivision (a)(3) would include the periodic evaluation of the continued need for and appropriateness of the delegation of authority. In particular circumstances, the trustee may need to terminate the delegation to comply with the duty under Section 16401(b)(3) (duty to use prudence in retaining agent). Section 16052 provides special exceptions to the general rule concerning delegation (Section 16012) and the trustee's liability for acts of agents (Section 16401). See also Section 16247 (power to hire accountants, auditors, investment advisors, etc.).

§ 16053. Language invoking standard of Uniform Prudent Investor Act

16053. The following terms or comparable language in the provisions of a trust, unless otherwise limited or modified, authorizes any investment or strategy permitted under this chapter: "investments permissible by law for investment of trust funds," "legal investments," "authorized investments," "using the judgment and care under the circumstances then prevailing that persons of prudence, discretion, and intelligence exercise in the management of their own affairs, not in regard to speculation but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of their capital," "prudent man rule," "prudent trustee rule," "prudent person rule," and "prudent investor rule."

Comment. Section 16053 is the same as Section 10 of the Uniform Prudent Investor Act (1994) and restates former Section 16042 without substantive change. See also Section 16045 (prudent investor rule defined).

§ 16054. Application to existing relationships

16054. This article applies to trusts existing on and created after its effective date. As applied to trusts existing on its effective date, this article governs only decisions or actions occurring after that date.

Comment. Section 16054 is the same as Section 11 of the Uniform Prudent Investor Act (1994) and is a specific application of the general transitional provisions in Section 3.

CONFORMING REVISIONS

Prob. Code § 16003 (amended). Duty to deal impartially with beneficiaries

SECTION 1. Section 16003 of the Probate Code is amended to read:

16003. If a trust has two or more beneficiaries, the trustee has a duty to deal impartially with them *and shall act impartially in investing and managing the trust property, taking into account any differing interests of the beneficiaries*.

Comment. Section 16003 is amended to provide additional detail drawn from Section 6 of the Uniform Prudent Investor Act (1994).

This section codifies the substance of Section 183 of the Restatement (Second) of Trusts (1957) and is in accord with prior case law. See Estate of Miller, 107 Cal. App. 438, 290 P. 528 (1930). For provisions permitting the beneficiaries to relieve the trustee from liability, see Sections 16463 (consent), 16464 (release), 16465 (affirmance). See also Sections 16000 (duties subject to control by trust instrument), 16040 (trustee's general standard of care in performing duties), 16046 (prudent investor rule), 16047 (standard of care, portfolio strategy, risk and return objectives).

Prob. Code § 16008 (repealed). Duty to dispose of improper investments

SEC. 2. Section 16008 of the Probate Code is repealed.

~~16008. (a) Except as provided in subdivision (b), the trustee has a duty within a reasonable time to dispose of any part of the trust property included in the trust at the time of its creation, or later acquired by or added to the trust, that would not be a proper investment for the trustee to make.~~

~~(b) Unless the trust instrument expressly provides otherwise, the trustee may, without liability, continue to hold property included in the trust at its creation or later added to the trust or acquired pursuant to proper authority, if retention is in the best interests of the trust or in furtherance of the purposes of the trust.~~

Comment. Section 16008 is superseded by the rules in Section 16048 (diversification) and 16049 (duties at inception of trusteeship).

Prob. Code § 16012 (amended). Duty not to delegate

SEC. 3. Section 16012 of the Probate Code is amended to read:

16012. (a) The trustee has a duty not to delegate to others the performance of acts that the trustee can reasonably be required personally to perform and may not transfer the office of trustee to another person nor delegate the entire administration of the trust to a cotrustee or other person.

(b) In a case where a trustee has properly delegated a matter to an agent, cotrustee, or other person, the trustee has a duty to exercise general supervision over the person performing the delegated matter.

(c) This section does not apply to investment and management functions under Section 16052.

Comment. Section 16012 is amended to recognize the special rule in Section 16052 applicable under the Uniform Prudent Investor Act (1994).

Subdivisions (a) and (b) continue Section 16012 of the repealed Probate Code without change. The first part of subdivision (a) codifies the substance of Section 171 of the Restatement (Second) of Trusts (1957). The second part of subdivision (a) codifies the substance of Section 4 of the Uniform Trustees' Powers Act (1964). As to the construction of provisions drawn from uniform acts, see Section 2. The duty not to delegate administration of the trust does not preclude employment of an agent in a proper case. A trust company may delegate matters involved in trust administration to its affiliates. For provisions permitting the beneficiaries to relieve the trustee from liability, see Sections 16463 (consent), 16464 (release), 16465 (affirmance). See also Sections 15620 (actions by cotrustees), 15621 (vacancy in office of cotrustee), 15622 (temporary incapacity of cotrustee), 16000 (duties subject to control by trust instrument), 16040 (trustee's general standard of care in performing duties), 16247 (power to hire agents of trust).

Subdivision (b) is drawn from comment k to Section 171 of the Restatement (Second) of Trusts (1957).

Prob. Code § 16040 (amended). Trustee's standard of care in administering trust

SEC. 4. Section 16040 of the Probate Code is amended to read:

16040. (a) The trustee shall administer the trust with ~~the~~ *reasonable* care, skill, ~~prudence, and diligence~~ *and caution* under the circumstances then prevailing that a prudent person acting in a like capacity ~~and familiar with such matters~~ would use in the conduct of an enterprise of like character and with like aims to accomplish the purposes of the trust as determined from the trust instrument.

(b) ~~When investing, reinvesting, purchasing, acquiring, exchanging, selling, and managing trust property, the trustee shall act with the care, skill, prudence, and diligence under the circumstances then prevailing, including but not limited to the general economic conditions and the anticipated needs of the trust and its beneficiaries, that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims to accomplish the purposes of the trust as determined from the trust instrument. In the course of administering the trust pursuant to this standard, individual investments shall be considered as part of an overall investment strategy.~~

~~(c)~~ The settlor may expand or restrict the ~~standards~~ *standard* provided in ~~subdivisions~~ *subdivision* (a) ~~and (b)~~ by express provisions in the trust instrument. A trustee is not liable to a beneficiary for the trustee's good faith reliance on these express provisions.

(c) This section does not apply to investment and management functions governed by the Uniform Prudent Investor Act, Article 2.5 (commencing with Section 16045).

Comment. Section 16040 is amended for harmony with the new Uniform Prudent Investor Act, Article 2.5 (commencing with Section 16045). This section provides a general standard of care that applies where the special, more detailed rule applicable to investments and management of trust property does not apply, such as determining whether to make discretionary distributions, communicating with beneficiaries, and relations with creditors. See subdivision (c).

The portfolio rule formerly provided by subdivision (b) is restated in Section 16047. Former subdivision (c) has been redesignated as subdivision (b) and revised to delete the reference to former subdivision (b). For a special rule protecting the trustee's good-faith reliance on trust provisions concerning investments, see Section 16046 (prudent investor rule).

Prob. Code § 16042 (repealed). Interpretation of trust terms concerning legal investments

SEC. 5. Section 16042 of the Probate Code is repealed.

~~16042. If a trust created before, on, or after July 1, 1987, refers to "investments permissible by law for investment of trust funds," "authorized by law for investment of trust funds," "legal investments," "authorized investments," or "investments acquired using the judgment and care which men of prudence, discretion, and intelligence exercise in the management of their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of their capital," or uses other words of similar meaning in defining the powers of the trustee relative to investments, such language, in the absence of other controlling or modifying provisions of the trust instrument, shall be construed as imposing the standard of care provided by Section 16040 and authorizing any investment permitted under Chapter 2 (commencing with Section 16200).~~

Comment. Section 16042 is continued without substantive change in Section 16053.

Prob. Code § 16200 (technical amendment). General powers of trustee

SEC. 7. Section 16200 of the Probate Code is amended to read:

16200. A trustee has the following powers without the need to obtain court authorization:

(a) The powers conferred by the trust instrument.

(b) Except as limited in the trust instrument, the powers conferred by statute.

(c) Except as limited in the trust instrument, the power to perform any act that a trustee would perform for the purposes of the trust under the standard of care provided in Section 16040 *or 16047*.

Comment. Subdivision (c) of Section 16200 is amended to recognize the authority provided in the Uniform Prudent Investor Act. See Sections 16045-16054.

This section is drawn from Sections 2(a) and 3(a) of the Uniform Trustees' Powers Act (1964) and from various California statutes that existed before the enactment of Section 16200 of the repealed Probate Code. As to the construction of provisions drawn from uniform acts, see Section 2.

The introductory clause of Section 16200 makes clear that the trustee has the powers as provided in this section without the need to obtain court authorization. See also Section 16201 (power of court to relieve trustee from restrictions on powers).

Subdivision (b) gives the trustee the statutory powers without the need to incorporate them. The main list of powers is provided in Article 2 (commencing with Section 16220). Additional powers are provided by statutes outside this chapter. See, e.g., Section 16300 *et seq.* (Revised Uniform Principal and Income Act).

Under subdivision (c), the trustee has the powers of a prudent person, without the need to obtain prior court approval. However, if the trustee desires court approval before exercising a power or desires court review after exercise of a power, the procedure provided in Section 17200 *et seq.* is available. This subdivision is drawn from Section 3(a) of the Uniform Trustees' Powers Act (1964). As to the construction of provisions drawn from uniform acts, see Section 2.

The exercise of powers by the trustee is subject to various important limitations as recognized in this section and as provided elsewhere. Subdivisions (b) and (c) make clear that the exercise of statutory or "prudent person" powers is subject to limitations provided in the trust. Section 16202 makes clear that the exercise of powers by the trustee is subject to the fiduciary duties owed to the beneficiaries. See Section 16202 Comment; see also Section 16201 (power of court to relieve trustee from restrictions on powers).

As to the construction of trust language that refers to "investments permissible by law for investment of trust funds," "authorized by law for investment of trust funds," "legal investments," "authorized investments," or "investments acquired using the judgment and care which men of prudence, discretion, and intelligence exercise in the management of their own affairs," or other words of similar meaning in defining the powers of the trustee relative to investments, see Section 16053.

Prob. Code § 16223 (repealed). Investments

SEC. 8. Section 16223 of the Probate Code is repealed.

~~16223. The trustee has the power to invest in any kind of property, whether real, personal, or mixed.~~

Comment. Section 16223 is replaced by Section 16047(e), which provides the same unrestricted power of investment under the Uniform Prudent Investor Act.

Prob. Code § 16401 (amended). Trustee's liability to beneficiary for acts of agent

SEC. 9. Section 16401 of the Probate Code is amended to read:

16401. (a) Except as provided in subdivision (b), the trustee is not liable to the beneficiary for the acts or omissions of an agent.

(b) ~~The~~ *Under any of the circumstances described in this subdivision, the* trustee is liable to the beneficiary for an act or omission of an agent employed by the trustee in the administration of the trust that would be a breach of the trust if committed by the trustee ~~under any of the following circumstances~~:

(1) Where the trustee ~~has the power to direct~~ *directs* the act of the agent.

(2) Where the trustee delegates to the agent the authority to perform an act that the trustee is under a duty not to delegate.

(3) Where the trustee does not use reasonable ~~care~~ *prudence* in the selection of the agent or the retention of the agent selected by the trustee.

(4) Where the trustee does not ~~exercise proper supervision over~~ *periodically review* the agent's ~~conduct in a case where the trustee has the power to supervise the agent~~ *overall performance and compliance with the terms of the delegation*.

(5) Where the trustee conceals the act of the agent.

(6) Where the trustee neglects to take reasonable steps to compel the agent to redress the wrong in a case where the trustee knows of the agent's acts or omissions.

(c) The liability of a trustee for acts or omissions of agents that occurred before July 1, 1987, is governed by prior law and not by this section.

Comment. Subdivision (b) of Section 16401 is amended for consistency with Section 16052 (delegation of investment and management functions), part of the Uniform Prudent Investor Act (1994). See Section 16052 & Comment. Subdivision (b)(1) is also revised in light of language in Section 225(2)(a) of the Restatement (Second) of Trusts (1957). Subdivision (b)(3) is amended to refer to the use of "prudence" which includes the elements of reasonable care, skill, and caution under Section 16040 (standard of care in non-investment functions) or Section 16047(a) (standard of care in investment and management functions under Uniform Prudent Investor Act). This is not intended to be a substantive change. Subdivision (b)(4) is amended to state a more concrete standard and to be consistent with the delegation rules governing investment and management under the Uniform Prudent Investor Act. See Section 16052(a).

Subdivisions (a) and (b) are drawn from Section 225 of the Restatement (Second) of Trusts (1957). Whether a trustee has acted reasonably under this section depends upon application of the standard of care provided in Section 16040. The trustee of a revocable trust is not liable where the agent's act is performed or omitted pursuant to the written instructions of the person having the power to revoke the trust. See Section 16462. Similarly, the trustee of a revocable trust is not liable for hiring an agent where the trustee is directed to do so in writing by the person having the power to revoke. See Section 16462. It should also be noted that the liability to beneficiaries does not include beneficiaries under a revocable trust during the time that the trust can be revoked. See Section 15800; see also Sections 15803 (holder of general power of appointment or power to withdraw property from trust treated as settlor), 16000 (duty to administer trust).

The six paragraphs of subdivision (b) state independent bases for imposition of liability on the trustee. For example, if the trustee has not used reasonable care in selecting or retaining an agent, the trustee may be held liable for the agent's breach under paragraph (3); but even if the trustee has no control over selection or retention of the agent, the trustee may still be held liable for the agent's breach under paragraph (1) if the trustee directed or permitted the agent's actions. It should also be noted that paragraphs (2), (5), and (6) of subdivision (b) apply regardless of whether the trustee has any control over the agent.

REVISED COMMENTS

Prob. Code § 2 (revised comment). Continuation of existing law; construction of provisions drawn from uniform acts

Comment. Section 2 continues Section 2 of the repealed Probate Code without change. See also Gov't Code §§ 9604 (reference made in statute, charter, or ordinance to provisions of one statute carried into another statute under circumstances in which they are required to be construed as restatements and continuations and not as new enactments), 9605 (construction of amended statutory provision).

Some of the provisions of this code are the same as or similar to provisions of uniform acts. Subdivision (b) provides a rule for interpretation of these provisions. Many of the provisions of this code are drawn from the Uniform Probate Code (1987). Some provisions are drawn from other uniform acts:

Sections 220-224 — Uniform Simultaneous Death Act (1953)
Sections 260-288 — Uniform Disclaimer of Transfers by Will, Intestacy or Appointment Act (1978)
Sections 260-288 — Uniform Disclaimer of Transfers Under Nontestamentary Instrument Act (1978)
Sections 3900-3925 — Uniform Transfers to Minors Act (1983)
Sections 4001, 4124-4127, 4206, 4304-4305 — Uniform Durable Power of Attorney Act
Sections 4400-4465 — Uniform Statutory Form Power of Attorney Act
Sections 6300-6303 — Uniform Testamentary Additions to Trusts Act (1960)
Sections 6380-6390 — Uniform International Wills Act (1977). See also Section 6387 (need for uniform interpretation of Uniform International Wills Act)
Sections 16002(a), 16003, 16045-16054 — Uniform Prudent Investor Act (1994)
Sections 16200-16249 — Uniform Trustees' Powers Act (1964)
Sections 16300-16313 — Revised Uniform Principal and Income Act (1962)

[remainder of Section 2 Comment unchanged]

Prob. Code § 15001 (revised comment). General rule concerning application of division

Comment. Section 15001 restates Section 15001 of the repealed Probate Code without substantive change. The language used in this section has been revised to reflect the fact that this division of the repealed Probate Code (the Trust Law) became operative on July 1, 1987.

Subdivision (a) provides the general rule that this division applies to all trusts, regardless of when created. Subdivision (a) is comparable to Section 8 of the Uniform Trustees' Powers Act (1964). As to the construction of provisions drawn from uniform acts, see Section 2. Subdivision (b), a specific application of the general rule stated in subdivision (a), makes clear that, except as otherwise provided by statute, this division applies to all proceedings commenced on or after July l, 1987. Subdivision (c) is a special provision concerning the application of this division to proceedings concerning trusts commenced before July 1, 1987.

For special transitional provisions, see Sections 15401(d) (application of rules governing method of revocation by settlor), 16053 (language invoking standard of Uniform Prudent Investor Act), 16054 (application of Uniform Prudent Investor Act to existing relationships), 16062(b)-(d) (application of duty to account to beneficiaries), 16203 (application of rules governing trustee's powers), 16401(c) (application of rules governing trustee's liability to beneficiary for acts of agent), 16402(c) (application of rules governing trustee's liability to beneficiary for acts of cotrustee), 16403(c) (application of rules governing trustee's liability to beneficiary for acts of predecessor trustee), 18000(b) (application of rule governing personal liability of trustee to third persons on contracts).

Prob. Code § 16000 (revised comment). Duty to administer trust

Comment. Section 16000 continues Section 16000 of the repealed Probate Code without change. This section is drawn in part from Sections 164 and 169 of the Restatement (Second) of Trusts (1957). See also Sections 15600 (acceptance of trust by trustee), 15800 (duties owed to person holding power to revoke), 15803 (duties owed to person with general power of appointment or power to withdraw trust property), 16001 (duties of trustee of revocable trust), 16040 (trustee's general standard of care in performing duties), 16046 (prudent investor rule), 16047 (standard of care, portfolio strategy, risk and return objectives), 16049 (duties at inception of trusteeship). For provisions permitting the beneficiaries to relieve the trustee from liability, see Sections 16463 (consent), 16464 (release), 16465 (affirmance).

Prob. Code § 16001 (revised comment). Duties of trustee of revocable trust

Comment. Section 16001 continues Section 16001 of the repealed Probate Code without change. The qualification in subdivision (a) that a direction be acceptable to the trustee does not mean that the trustee is required to determine the propriety of the direction. For the rule protecting the trustee from liability for following directions under this section, see Section 16462. See also Sections 15800 (duties owed to person holding power to revoke), 16000 (duties subject to control in trust instrument), 16040 (trustee's general standard of care in performing duties), 16046 (prudent investor rule), 16047 (standard of care, portfolio strategy, risk and return objectives).

Subdivision (b) clarifies the relationship between the duty to follow directions provided in subdivision (a) and the rules governing modification of trusts. See Sections 15401 (method of revocation by settlor), 15402 (power to revoke includes power to modify).

Prob. Code § 16002 (revised comment). Duty of loyalty

Comment. Section 16002 continues Section 16002 of the repealed Probate Code without change. Subdivision (a) codifies the substance of Section 170(1) of the Restatement (Second) of Trusts (1957). Subdivision (a) is also included within the Uniform Prudent Investor Act (1994). See Section 16045 & Comment. See also Sections 16000 (duties subject to control by trust instrument), 16040 (trustee's general standard of care in performing duties), 16046 (prudent investor rule), 16047 (standard of care, portfolio strategy, risk and return objectives). This article does not attempt to state all aspects of the trustee's duty of loyalty, nor does this article seek to cover all duties that may exist. See Section 15002 (common law as law of state). See also Section 16015 (certain actions not violations of duties). For provisions permitting the beneficiaries to relieve the trustee from liability, see Sections 16463 (consent), 16464 (release), 16465 (affirmance).

Subdivision (b) is drawn from Indiana law. See Ind. Code Ann. § 30-4-3-7(d) (West Supp. 1988). This subdivision permits sales or exchanges between two or more trusts that have the same trustee without running afoul of the duty of loyalty. See Restatement (Second) of Trusts § 170 comment r (1957). Subdivision (b) does not require the trustee to give notice to all beneficiaries of both trusts; for limitations on the need to give notice, see Sections 15802 (notice to beneficiary of revocable trust) and 15804 (notice in case involving future interest of beneficiary). See also Sections 15800 (limits on rights of beneficiary of revocable trust), 15801 (consent of beneficiary of revocable trust).

Prob. Code § 16004 (revised comment). Duty to avoid conflict of interest

Comment. Section 16004 continues Section 16004 of the repealed Probate Code without change. For provisions permitting the beneficiaries to relieve the trustee from liability, see Sections 16463 (consent), 16464 (release), 16465 (affirmance). See also Sections 16000 (duties subject to control by trust instrument), 16015 (certain actions not violations of duties), 16040 (trustee's general standard of care in performing duties), 16046 (prudent investor rule), 16047 (standard of care, portfolio strategy, risk and return objectives).

The court referred to in subdivision (b) may be the court where the trust is administered, such as where the trustee seeks reimbursement for the claim under Section 17200(b), or the court where enforcement of the claim is sought, such as where the trustee seeks to foreclose a lien or seeks recognition of the claim in proceedings commenced by some other creditor.

Prob. Code § 16005 (revised comment). Duty not to undertake adverse trust

Comment. Section 16005 continues Section 16005 of the repealed Probate Code without change. For provisions permitting the beneficiaries to relieve the trustee from liability, see Sections 16463 (consent), 16464 (release), 16465 (affirmance). See also Sections 16000 (duties subject to control by trust instrument), 16040 (trustee's general standard of care in performing duties), 16046 (prudent investor rule), 16047 (standard of care, portfolio strategy, risk and return objectives).

Prob. Code § 16006 (revised comment). Duty to take control of and preserve trust property

Comment. Section 16006 continues Section 16006 of the repealed Probate Code without change. This section codifies the substance of Sections 175 and 176 of the Restatement (Second) of Trusts (1957). The section is in accord with prior case law. See, e.g., Purdy v. Bank of America Nat'l Tr. & Sav. Ass'n, 2 Cal. 2d 298, 302-04, 40 P.2d 481 (1935); Estate of Duffill, 188 Cal. 536, 547, 206 P. 42 (1922); Martin v. Bank of America Nat'l Tr. & Sav. Ass'n, 4 Cal. App. 2d 431, 436, 41 P.2d 200 (1935). For provisions permitting the beneficiaries to relieve the trustee from liability, see Sections 16463 (consent), 16464 (release), 16465 (affirmance). See also Sections 16000 (duties subject to control by trust instrument), 16040 (trustee's general standard of care in performing duties), 16046 (prudent investor rule), 16047 (standard of care, portfolio strategy, risk and return objectives).

Prob. Code § 16007 (revised comment). Duty to make trust property productive

Comments. Section 16007 continues Section 16007 of the repealed Probate Code without change. The section codifies the substance of Section 181 of the Restatement (Second) of Trusts (1957). For the trustee's standard of care governing investments and management of trust property, see Section 16047. In appropriate circumstances under Section 16007, property may be made productive by appreciation in value rather than by production of income. If the trust instrument imposes a duty on the trustee to hold property and give possession of it to a beneficiary at a later date, this duty would override the general duty to make the property productive. See Restatement (Second) of Trusts § 181 comment a (1957). Similarly, if a beneficiary has the right under the trust instrument to occupy a home, the trustee would have no duty to make the property productive of income. For provisions permitting the beneficiaries to relieve the trustee from liability, see Sections 16463 (consent), 16464 (release), 16465 (affirmance). See also Sections 16000 (duties subject to control by trust instrument), 16046(b) (prudent investor rule subject to control by trust instrument).

Prob. Code § 16009 (revised comment). Duty to keep trust property separate and identified

Comment. Section 16009 continues Section 16009 of the repealed Probate Code without change. This section codifies the substance of Section 179 of the Restatement (Second) of Trusts (1957), but the Restatement provision for keeping trust property separate from the trustee's individual property is omitted since it is redundant with subdivision (a). For exceptions to this general duty, see, e.g., Fin. Code §§ 1563 (securities registered in name of nominee), 1564 (Uniform Common Trust Fund Act). For provisions permitting the beneficiaries to relieve the trustee from liability, see Sections 16463 (consent), 16464 (release), 16465 (affirmance). See also Sections 16000 (duties subject to control by trust instrument), 16040 (trustee's general standard of care in performing duties), 16046 (prudent investor rule), 16047 (standard of care, portfolio strategy, risk and return objectives).

Prob. Code § 16010 (revised comment). Duty to enforce claims

Comment. Section 16010 continues Section 16010 of the repealed Probate Code without change. This section codifies the substance of Section 177 of the Restatement (Second) of Trusts (1957) and is in accord with prior case law. See Ellig v. Naglee, 9 Cal. 683, 695-96 (1858). Depending upon the circumstances of the case, it might not be reasonable to enforce a claim in view of the likelihood of recovery and the cost of suit and enforcement. For provisions permitting the beneficiaries to relieve the trustee from liability, see Sections 16463 (consent), 16464 (release), 16465 (affirmance). See also Sections 16000 (duties subject to control by trust instrument), 16040 (trustee's general standard of care in performing duties), 16046 (prudent investor rule), 16047 (standard of care, portfolio strategy, risk and return objectives).

Prob. Code § 16011 (revised comment). Duty to defend actions

Comment. Section 16011 continues Section 16011 of the repealed Probate Code without change. This section codifies the substance of the first part of Section 178 of the Restatement (Second) of Trusts (1957) and is in accord with prior case law. See, e.g., Estate of Duffill, 188 Cal. 536, 554-55, 206 P. 42 (1922). Depending on the circumstances of the case, it might be reasonable to settle an action or suffer a default rather than to defend an action. For provisions permitting the beneficiaries to relieve the trustee from liability, see Sections 16463 (consent), 16464 (release), 16465 (affirmance). See also Sections 16000 (duties subject to control by trust instrument), 16040 (trustee's general standard of care in performing duties), 16046 (prudent investor rule), 16047 (standard of care, portfolio strategy, risk and return objectives).

Prob. Code § 16013 (revised comment). Duty with respect to cotrustees

Comment. Section 16013 continues Section 16013 of the repealed Probate Code without change. This section codifies the substance of Section 184 of the Restatement (Second) of Trusts (1957) and is in accord with prior case law. See Bermingham v. Wilcox, 120 Cal. 467, 471-73, 52 P. 822 (1898). For provisions permitting the beneficiaries to relieve the trustee from liability, see Sections 16463 (consent), 16464 (release), 16465 (affirmance). See also Sections 16000 (duties subject to control by trust instrument), 16040 (trustee's general standard of care in performing duties), 16402 (trustee's liability to beneficiary for acts of cotrustee), 16046 (prudent investor rule), 16047 (standard of care, portfolio strategy, risk and return objectives). If one cotrustee is also a settlor under a revocable trust, another cotrustee who is not a settlor has a duty to follow the directions of the settlor-cotrustee pursuant to Section 16001. That duty supersedes the general duty under this section.

Prob. Code § 16014 (revised comment). Duty to use special skills

Comment. Section 16014 continues Section 16014 of the repealed Probate Code without change. Subdivision (a) codifies a duty set forth in Coberly v. Superior Court, 231 Cal. App. 2d 685, 689, 42 Cal. Rptr. 64 (1965).

Subdivision (b) is similar to the last part of Section 7-302 of the Uniform Probate Code (1987) and the last part of Section 174 of the Restatement (Second) of Trusts (1957). As to the construction of provisions drawn from uniform acts, see Section 2. Subdivision (b) does not limit the duty provided in subdivision (a). Thus, the nature of the trustee's representations to the settlor leading up to the selection of the trustee does not affect the trustee's duty to use the full extent of his or her skills.

For provisions permitting the beneficiaries to relieve the trustee from liability, see Sections 16463 (consent), 16464 (release), 16465 (affirmance). See also Sections 16000 (duties subject to control by trust instrument), 16040 (trustee's general standard of care in performing duties), 16046 (prudent investor rule), 16047 (standard of care, portfolio strategy, risk and return objectives).

Prob. Code § 16201 (revised comment). Power of court to relieve trustee from restrictions on powers

Comments. Section 16201 continues Section 16201 of the repealed Probate Code without change. This section did not change the prior case law rule permitting deviation from trust restrictions as necessary in unforeseen circumstances. See, e.g., Estate of Loring, 29 Cal. 2d 423, 436-37, 175 P.2d 524 (1946); Adams v. Cook, 15 Cal. 2d 352, 359, 101 P.2d 484 (1940); Estate of Mabury, 54 Cal. App. 3d 969, 984-85, 127 Cal. Rptr. 233 (1976); see also Restatement (Second) of Trusts § 167 (1957). For a provision permitting the court to modify a trust where there has been a material change of circumstances, see Section 15409. As to the construction of trust language that refers to "investments permissible by law for investment of trust funds," "authorized by law for investment of trust funds," "legal investments," "authorized investments," or "investments acquired using the judgment and care which men of prudence, discretion, and intelligence exercise in the management of their own affairs," or other words of similar meaning in defining the powers of the trustee relative to investments, see Section 16053.

Prob. Code § 16202 (revised comment). Exercise of powers subject to trustee's duties

Comments. Section 16202 continues Section 16202 of the repealed Probate Code without change. This section recognizes that a power granted to the trustee from any source does not necessarily permit the exercise of the power, nor does it prevent the exercise of a power in a manner that conflicts with a general duty where the trust instrument so directs (see Section 16000) or where the trustee is directed so to act by a person holding the power to revoke the trust (see Section 16001). For example, the trust instrument may give the trustee discretion to favor one beneficiary over others, in apparent conflict with the general duty to deal with beneficiaries impartially under Section 16003. See also Section 16000 *et seq.* (trustee's fiduciary duties). As to the construction of trust language that refers to "investments permissible by law for investment of trust funds," "authorized by law for investment of trust funds," "legal investments," "authorized investments," or "investments acquired using the judgment and care which men of prudence, discretion, and intelligence exercise in the management of their own affairs," or other words of similar meaning in defining the powers of the trustee relative to investments, see Section 16053.

Prob. Code § 16203 (revised comment). Application of rules governing trustees' powers

Comment. Section 16203 continues Section 16203 of the repealed Probate Code with technical changes. This section makes clear the effect of references in instruments to the former provisions listing trustees' powers. As to the construction of trust language that refers to "investments permissible by law for investment of trust funds," "authorized by law for investment of trust funds," "legal investments," "authorized investments," or "investments acquired using the judgment and care which men of prudence, discretion, and intelligence exercise in the management of their own affairs," or other words of similar meaning in defining the powers of the trustee relative to investments, see Section 16053.

Prob. Code § 16220 (revised comment). Collecting and holding property

Comment. Section 16220 continues Section 16220 of the repealed Probate Code without change. This section is the same in substance as Section 3(c)(1) of the Uniform Trustees' Powers Act (1964). As to the construction of provisions drawn from uniform acts, see Section 2. The exercise of the power to hold property under this section is subject to the limitation provided in Section 21524(c) in the case of a marital deduction trust. See also Sections 62 ("property" defined), 16053 (language invoking standard of Uniform Prudent Investor Act), 16202 (exercise of powers is subject to duties), 16203 (trust instrument that incorporates the powers provided in former Section 1120.2 of the repealed Probate Code).

Prob. Code § 16222 (revised comment). Participation in business; change in form of business

Comment. Section 16222 continues Section 16222 of the repealed Probate Code without change. Subdivision (a) is similar to Section 3(c)(3) of the Uniform Trustees' Powers Act (1964). As to the construction of provisions drawn from uniform acts, see Section 2. Under Section 16222, the trustee may have the power to continue a business that is made part of the trust, but may not enter into a new business. See also 16053 (language invoking standard of Uniform Prudent Investor Act), 16202 (exercise of powers is subject to duties), 16203 (trust instrument that incorporates the powers provided in former Section 1120.2 of the repealed Probate Code).

Subdivision (b) excludes the lease of four or fewer residential units from the requirement that the trustee obtain court approval to continue operation of a business or other enterprise that is a part of trust property. It is irrelevant whether the residential units are located in one or more buildings or on one or more lots.

Subdivision (d) limits the rule in subdivision (b) requiring court authorization for the trustee to operate a business or other enterprise that is a part of trust property. This is a special application of the rule stated in Section 16203.

Prob. Code § 16224 (revised comment). Investments in obligations of United States government

Comment. Section 16224 continues Section 16224 of the repealed Probate Code without change. See also Sections 16053 (language invoking standard of Uniform Prudent Investor Act), 16202 (exercise of powers is subject to duties), 16203 (trust instrument that incorporates the powers provided in former Section 1120.2 of the repealed Probate Code).

Prob. Code § 16226 (revised comment). Acquisition and disposition of property

Comment. Section 16226 continues Section 16226 of the repealed Probate Code without change. This section is the same in substance as part of Section 3(c)(7) of the Uniform Trustees' Powers Act (1964). As to the construction of provisions drawn from uniform acts, see Section 2. See also Sections 62 ("property" defined), 16053 (language invoking standard of Uniform Prudent Investor Act), 16202 (exercise of powers is subject to duties), 16203 (trust instrument that incorporates the powers provided in former Section 1120.2 of the repealed Probate Code).

Prob. Code § 16227 (revised comment). Management of property

Comment. Section 16227 continues Section 16227 of the repealed Probate Code without change. This section is the same in substance as part of Section 3(c)(7) of the Uniform Trustees' Powers Act (1964). As to the construction of provisions drawn from uniform acts, see Section 2. See also Sections 62 ("property" defined), 16053 (language invoking standard of Uniform Prudent Investor Act), 16202 (exercise of powers is subject to duties), 16203 (trust instrument that incorporates the powers provided in former Section 1120.2 of the repealed Probate Code).

Prob. Code § 16228 (revised comment). Encumbrances

Comment. Section 16228 continues Section 16228 of the repealed Probate Code without change. This section is the same in substance as part of Section 3(c)(7) of the Uniform Trustees' Powers Act (1964). As to the construction of provisions drawn from uniform acts, see Section 2. See also Sections 62 ("property" defined), 16053 (language invoking standard of Uniform Prudent Investor Act), 16202 (exercise of powers is subject to duties), 16203 (trust instrument that incorporates the powers provided in former Section 1120.2 of the repealed Probate Code).

Prob. Code § 16229 (revised comment). Repairs and alterations of property

Comment. Section 16229 continues Section 16229 of the repealed Probate Code without substantive change. This section is the same in substance as Section 3(c)(8) of the Uniform Trustees' Powers Act (1964). As to the construction of provisions drawn from uniform acts, see Section 2.

See also Sections 16053 (language invoking standard of Uniform Prudent Investor Act), 16202 (exercise of powers is subject to duties), 16203 (trust instrument that incorporates the powers provided in former Section 1120.2 of the repealed Probate Code).

Prob. Code § 16230 (revised comment). Development of land

Comment. Section 16230 continues Section 16230 of the repealed Probate Code without change. This section is the same in substance as Section 3(c)(9) of the Uniform Trustees' Powers Act (1964). As to the construction of provisions drawn from uniform acts, see Section 2. See also Sections 16053 (language invoking standard of Uniform Prudent Investor Act), 16202 (exercise of powers is subject to duties), 16203 (trust instrument that incorporates the powers provided in former Section 1120.2 of the repealed Probate Code).

Prob. Code § 16231 (revised comment). Leases

Comment. Section 16231 continues Section 16231 of the repealed Probate Code without change. This section is the same in substance as Section 3(c)(10) of the Uniform Trustees' Powers Act (1964). As to the construction of provisions drawn from uniform acts, see Section 2. See also Sections 16053 (language invoking standard of Uniform Prudent Investor Act), 16202 (exercise of powers is subject to duties), 16203 (trust instrument that incorporates the powers provided in former Section 1120.2 of the repealed Probate Code).

Prob. Code § 16232 (revised comment). Mineral leases

Comment. Section 16232 continues Section 16232 of the repealed Probate Code with the addition of a reference to geothermal energy. The reference to a pooling or unitization agreement is drawn from Section 3(c)(11) of the Uniform Trustees' Powers Act (1964). As to the construction of provisions drawn from uniform acts, see Section 2. The authority to make leases or agreements extending beyond the term of the trust is consistent with Section 16231 (general power to lease). See also Sections 16053 (language invoking standard of Uniform Prudent Investor Act), 16202 (exercise of powers is subject to duties), 16203 (trust instrument that incorporates the powers provided in former Section 1120.2 of the repealed Probate Code).

Prob. Code § 16233 (revised comment). Options

Comment. Section 16233 continues Section 16233 of the repealed Probate Code without change. This section is the same in substance as Section 3(c)(12) of the Uniform Trustees' Powers Act (1964). As to the construction of provisions drawn from uniform acts, see Section 2. The authority to grant or take options exercisable beyond the term of the trust is consistent with Section 16231 (general power to lease). An option under this section includes a right of first refusal. See also Sections 62 ("property" defined), 16053 (language invoking standard of Uniform Prudent Investor Act), 16202 (exercise of powers is subject to duties), 16203 (trust instrument that incorporates the powers provided in former Section 1120.2 of the repealed Probate Code).

Prob. Code § 16234 (revised comment). Voting rights with respect to corporate shares, memberships, or property

Comment. Section 16234 continues Section 16234 of the repealed Probate Code without change. This section is comparable to Section 2458 (voting rights under guardianship and conservatorship statute). See also Corp. Code §§ 702(a) (voting of shares by trustee), 703(c) (voting of shares in corporate trustee), 705 (proxies); Prob. Code §§ 16053 (language invoking standard of Uniform Prudent Investor Act), 16202 (exercise of powers is subject to duties), 16203 (trust instrument that incorporates the powers provided in former Section 1120.2 of the repealed Probate Code).

Prob. Code § 16235 (revised comment). Payment of calls and assessments

Comment. Section 16235 continues Section 16235 of the repealed Probate Code without change. This section is the same as Section 3(c)(14) of the Uniform Trustees' Powers Act (1964). As to the construction of provisions drawn from uniform acts, see Section 2. See also Sections 16053 (language invoking standard of Uniform Prudent Investor Act), 16202 (exercise of powers is subject to duties), 16203 (trust instrument that incorporates the powers provided in former Section 1120.2 of the repealed Probate Code).

Prob. Code § 16236 (revised comment). Stock subscriptions and conversions

Comment. Section 16236 continues Section 16236 of the repealed Probate Code without change. This section is the same as the first part of Section 3(c)(15) of the Uniform Trustees' Powers Act (1964). As to the construction of provisions drawn from uniform acts, see Section 2. See also Sections 16053 (language invoking standard of Uniform Prudent Investor Act), 16202 (exercise of powers is subject to duties), 16203 (trust instrument that incorporates the powers provided in former Section 1120.2 of the repealed Probate Code).

Prob. Code § 16237 (revised comment). Consent to change in form of business; voting trusts

Comment. Section 16237 continues Section 16237 of the repealed Probate Code without substantive change. This section, in part, is similar to the second part of Section 3(c)(15) of the Uniform Trustees' Powers Act (1964). As to the construction of provisions drawn from uniform acts, see Section 2. See also Sections 16053 (language invoking standard of Uniform Prudent Investor Act), 16202 (exercise of powers is subject to duties), 16203 (trust instrument that incorporates the powers provided in former Section 1120.2 of the repealed Probate Code).

Prob. Code § 16238 (revised comment). Holding securities in name of nominee

Comment. Section 16238 continues Section 16238 of the repealed Probate Code, but deletes the reference to the liability of the trustee for an act of the nominee for consistency with Section 9736 (decedent's estate management). This matter is governed by general provisions on liability of a trustee. See, e.g., Section 16401. This section is comparable to Section 3(c)(16) of the Uniform Trustees' Powers Act (1964). As to the construction of provisions drawn from uniform acts, see Section 2. See also Corp. Code § 702(a) (trustee not entitled to vote shares without transfer into trustee's name); Fin. Code § 1563 (trust company may register securities in name of nominee); Prob. Code §§ 16053 (language invoking standard of Uniform Prudent Investor Act), 16202 (exercise of powers is subject to duties), 16203 (trust instrument that incorporates the powers provided in former Section 1120.2 of the repealed Probate Code).

Prob. Code § 16239 (revised comment). Deposit of securities in securities depository

Comment. Section 16239 continues Section 16239 of the repealed Probate Code without change. See also Sections 16053 (language invoking standard of Uniform Prudent Investor Act), 16200 (powers subject to control by trust instrument), 16202 (exercise of powers is subject to duties), 16203 (trust instrument that incorporates the powers provided in former Section 1120.2 of the repealed Probate Code).

Prob. Code § 16240 (revised comment). Insurance

Comment. Section 16240 continues Section 16240 of the repealed Probate Code without change. This section is the same in substance as Section 3(c)(17) of the Uniform Trustees' Powers Act (1964). As to the construction of provisions drawn from uniform acts, see Section 2. See also Sections 62 ("property" defined), 16053 (language invoking standard of Uniform Prudent Investor Act), 16202 (exercise of powers is subject to duties), 16203 (trust instrument that incorporates the powers provided in former Section 1120.2 of the repealed Probate Code).

Prob. Code § 16241 (revised comment). Borrowing money

Comment. Section 16241 continues Section 16241 of the repealed Probate Code without change. The first sentence of this section is similar to part of Section 3(c)(18) of the Uniform Trustees' Powers Act (1964). As to the construction of provisions drawn from uniform acts, see Section 2. See also Sections 62 ("property" defined), 16053 (language invoking standard of Uniform Prudent Investor Act), 16202 (exercise of powers is subject to duties), 16203 (trust instrument that incorporates the powers provided in former Section 1120.2 of the repealed Probate Code).

Prob. Code § 16242 (revised comment). Payment and settlement of claims

Comment. Section 16242 continues Section 16242 of the repealed Probate Code without change. This section is substantially the same as Section 3(c)(19) of the Uniform Trustees' Powers Act (1964). As to the construction of provisions drawn from uniform acts, see Section 2. The trustee has the power to release a claim; the determination of when to release a claim depends upon the duties imposed on the trustee. As a general matter, the trustee should be able to release a claim not only when it is uncollectible, but also when it is uneconomical to attempt to collect it. See also Sections 16010 (duty to enforce claims), 16011 (duty to defend actions), 16053 (language invoking standard of Uniform Prudent Investor Act), 16202 (exercise of powers is subject to duties), 16203 (trust instrument that incorporates the powers provided in former Section 1120.2 of the repealed Probate Code).

Prob. Code § 16247 (revised comment). Hiring persons

Comment. Section 16247 is the same in substance as part of Section 3(c)(24) of the Uniform Trustees' Powers Act (1964). As to the construction of provisions drawn from uniform acts, see Section 2. If the trustee is in doubt concerning the propriety of hiring an agent, the judicial procedure for obtaining instructions is available. See Section 17200(b)(6). An agent with a close relationship with the trustee or an insider may be hired when it is in the best interests of the trust, taking into account the duty of loyalty (see Section 16002) and the duty to avoid conflicts of interest (see Section 16004), and particularly as to routine matters; but in situations involving substantial matters, it is best to hire outside agents. The trustee has a duty to inform certain beneficiaries of agents hired, their relationship to the trustee, if any, and their compensation. See Section 16063(d).

See also Sections 16012 (general duty not to delegate), 16014 (duty to use special skills), 16052 (delegation of investment and management functions), 16202 (exercise of powers is subject to duties), 16401 (trustee's liability to beneficiary for acts of agent).

Prob. Code § 16311 (revised comment). Underproductive property

Comment. Subdivision (d) of Section 16311 resolves the conflict between the portfolio approach to investment decisions provided in Section 16047 and the underproductive property provision of Section 16311 as it applies to securities.

Prob. Code § 16440 (revised comment). Measure of liability for breach of trust

Comment. Section 16440 continues Section 16440 of the repealed Probate Code without change. Subdivision (a) is drawn from Section 205 of the Restatement (Second) of Trusts (1957). See also Section 16047 (duty to consider investments as part of an overall investment strategy under Uniform Prudent Investor Act).

Subdivision (b) codifies the good-faith exception to the general liability rules found in the Restatement. See Restatement (Second) of Trusts § 205 comment g (1957). This rule supersedes subdivision (a) of former Civil Code Section 2238 and represents an expansion of the rule in Estate of Talbot, 141 Cal. App. 2d 309, 320-27, 296 P.2d 848 (1956). In *Talbot,* liability for appreciation damages was excused on the grounds of good faith, but the trustee was liable for the breach in the amount of the loss to the corpus plus interest.