Study L-649 March 17, 1998

Second Supplement to Memorandum 98-19

Uniform Principal and Income Act: Preliminary Considerations (Letter from Prof. Dobris & State Bar Memorandum)

Attached to this supplement are letters from Professor Joel C. Dobris, Co-Reporter on the Uniform Principal and Income Act, and from James Deeringer forwarding comments of members of the State Bar Estate Planning, Trust and Probate Law Section Executive Committee. We will discuss these comments as relevant to issues that come up at the meeting. Issues that are not addressed will be considered at a later meeting, assuming the Commission decides to proceed with this study.

Prof. Dobris notes that the new UPAIA has two purposes. It updates the "nuts and bolts rules of principal/income allocation" and provides a "solution to the 'problem' that proper total return investing under the Prudent Investor Rule can easily lead to returns that are superior, but that contain little or no traditional income for the income beneficiary." (Exhibit p. 1.)

The State Bar materials are provided to assist the Commission at the March meeting and have not been discussed by the Executive Committee as a whole, as noted on Exhibit p. 7. With respect to the adjustment power in UPAIA Section 104, the State Bar memorandum finds it "appealing in theory" but having "numerous problems … in practice." (Exhibit pp. 9-12.) Like the California Bankers Association, the primary concern is the potential liability exposure for trustees in the exercise of discretion under Section 104.

Respectfully submitted,

Stan Ulrich
Assistant Executive Secretary

UNIVERSITY OF CALIFORNIA, DAVIS

BERKELEY • DAVIS • IRVINE • LOS ANGELES • RIVERSIDE • SAN DIEGO • SAN FRANCISCO SANTA BARBARA • SANTA CRUZ

SCHOOL OF LAW DAVIS, CALIFORNIA 95616-5201

March 15, 1998

Law Revision Commission
RECEIVED

MAR 17 1998

File:

Stan Ulrich
Assistant Executive Secretary
California Law Revision Commission
4000 Middlefield Road, Room D-1
Palo Alto, CA 94303-4739
TELE: 650 494 1335

Dear Mr. Ulrich:

I am a law professor at the School of Law at the University of California at Davis. I am a co-reporter for the Uniform Principal and Income Act (1997). I am writing you with my comments regarding California adopting this new uniform act.

I am in favor of the act.

The act has two purposes: (1) to update the nuts and bolts rules of principal/income allocation and (2) to provide a solution to the "problem" that proper total return investing under the Prudent Investor Rule can easily lead to returns that are superior, but that contain little or no traditional income for the income beneficiary. Trustees are now free to invest in anything, and anything doesn't always crank out a convenient stream of traditional income.

The nuts and bolts revisions are top-notch, represent thousands of human hours of work and should be adopted.

The Modern-Portfolio-Theory/total-return solution is an equitable adjustment power to be found in Section 104 of the new act. If a trustee invests wisely and well, applies the basic terms of the act and finds that the allocation is initially unfair to income or principal, then the trustee has the power to adjust return so that it is impartial.

Modern prudent investing creates the problem discussed above -- trust portfolio return may not come to the trustee in a neat package. There are three basic solutions for sale. One, do nothing, because "there is no problem" -- there is no train coming down the tracks and everyone I know agrees with me. Two, allow trustees to make a limited equitable adjustment only if it's needed (that's Section 104). Three, convert some or all trusts, on some basis, into something else. Something else may be a unitrust or a discretionary trust. The unitrust is said to be under consideration in at least one money center state.

Equitable adjustment is the Goldilocks solution -- not too hot and not too cold. It is the wisest and least disturbing solution to a problem that must be faced. It, too, is the product of years of consideration, debate and compromise. It, too, is top-notch.

* * *

Here are some specific comments from me on items you have received.

First, I have the following comments re the David Lauer letter. I refer to the larger page numbers at the bottom of your pages. Thus the discussion of 104 begins on a page that is labelled both small number 3 and large number 4. I will refer to that page as 4. I am on page 4.

I refer to the first paragraph of the Section 104 discussion.

I say, a trustee always refers to all relevant factors and to no irrelevant factors. To do otherwise is a breach of trust.

The list of possibly relevant factors is taken from the Uniform Prudent Investor Act, is a convenience for the trustee, and is likely to be a complete list of factors for most trustees.

I refer to the last paragraph on page 4.

I disagree that most of the concepts that constitute modern portfolio theory as found in the UPIA have been in California law for 15 years.

Even if they have, the investment climate has changed so much in the last few years that California experience in the 1980s, and even the early 1990s, is not instructive. The problems are really just starting now. A wisely-chosen portfolio can easily earn less than 2% traditional income. The trustee who wants to prudently buy that portfolio cannot do so, unless s/he has a power to pay principal to the income beneficiary.

I refer to the numbered paragraphs on page 5.

Paragraph 1. As I wrote above a trustee always refers to all relevant factors and does not refer to irrelevant factors. To do otherwise is a breach of trust. Today, in California, that is the law. Trustees are second-guessed and their decisions are viewed in hindsight all the time. That is what they get paid for. Trustees have to consider inflation and deflation, now. If they don't, they can be sued, successfully.

Paragraph 2. A trustee must always consider the settlor's intent. To do otherwise is a breach of trust. Today, in California, that is the law.

Paragraph 3. The trustee is precluded from making adjustments that have adverse tax consequences. This has many purposes, including protecting trustees from surcharge. Trustees make tax-oriented decisions all the time. They do not have to hire counsel each time they make such decisions.

Paragraph 4. This argument proves too much. It would preclude the trustee from making any investment decision or any decision that would affect the value of trust principal.

Paragraph 5. The reference to liability for purchase of a single asset suggests to me that the author of this comment may not have internalized the nature of portfolio investing. The number of occasions when a single asset purchase will lead to liability is now very small. The adjustment simplifies investing. It does not complicate it. The trustee can simply invest for total return without worrying about the form of the return.

Paragraph 6. The majority of trusts will need no adjustments and the majority of trustees will soldier on as they have in the past. A small population of trustees -- that will grow over the years -- will come to appreciate the availability of adjustment power as they invest under UPIA. Section 104 is the spare tire and jack in the back of the car. You carry them in case you need them. It is always annoying to change a tire if you do get a flat, but it's nice to have the tools.

Paragraph 7. The basic model of trustee conduct is act wisely and account in the future. The trustee has dozens of discretions. Virtually none of them lead to petitions for approval. The model will hold true for Section 104. The bankers predict thousands of petitions for adjustment approval. I predict very, very few.

Paragraph 8. The tax implications are not unclear.

Paragraph 9. If the beneficiaries are prone to hostility then they will be hostile. A trust is about money and about people, whether there is a Section 104 or not. When there are money and people involved, there's always a potential for hostility. The greater likelihood for hostility comes from poor trustee investment performance, overall, because the trustee cannot invest as s/he chooses. Poor overall performance, because the best investments for the trust in question can't be used, because they don't generate enough traditional income, is worse than having to make adjustments.

Paragraph 10. If banks cannot control their investment personnel then banks have a big problem, one that cannot be solved by refusing to enact Section 104. Diversification is to be defined for each trust. The allocation between equity and debt should be made for each trust on a portfolio basis after an analysis of risk and without regard to the form of return. A trustee should never make (or have to make) a decision to buy debt, just to buy an income stream. A trustee should buy bonds because the trust portfolio needs some bonds for investment purposes.

The memo fails to understand a trustee should never buy bonds s/he doesn't want, just to get an income stream. This is demonstrated by the comment to Section 425 on page 11. The reader is told that if the trust contains assets unproductive of income that the trustee can always buy some income producing assets in other parts of the portfolio. WHAT IF THE TRUSTEE DOES NOT WANT TO BUY THOSE ASSETS? What if the trustee believes the best portfolio for the trust does not include income assets sufficient to produce the necessary income for the beneficiary? California must have an answer to this question.

The complaint about the possible conduct of bank <u>investment</u> personnel highlights an important problem that the Law Revision Commission should focus on. Bank <u>investment</u> personnel have embraced Modern Portfolio Theory because it is a better way of investing. It's so good it's mandated by UPIA and the Restatement. Bank <u>administrative</u> personnel have not yet come to terms with MPT. The typical bank trust department has two sides. They have got to communicate with each other. This is a banking industry problem that should not determine the Law Revision Commission's agenda.

Paragraph 11. Pre-existing trusts were established to provide in the best possible way for the settlor's beneficiaries. No settlor wanted poor returns for beneficiaries in order to preserve a package of administrative powers in a trust. Settlors didn't think about adjustments. They did think about their beneficiaries. Again, the memo proves too much. The argument would prevent the use of UPIA and any statute that improves the administration of trusts by giving trustees new powers.

* * *

Second, I have the following comments re Alexander Misheff's letter of February 9, 1998, on pages 15 and 16.

Paragraph 1. I think the memo of 1995 does not meaningfully inform the discussion of the final version of the Act in 1998 except to show that some persons on a bankers committee in 1995 did not like a different version of the act.

Paragraph 2 makes six points. These are my comments.

First subparagraph: I hope that agitation for reform is not the Law Revision Commission's precondition to act. The National

Conference offers law reform proposals for the good of society. This process took almost a decade. If the Law Revision Commission waits until the train comes down the track, until there is agitation for reform, providing for the problem of total return will be done in a hasty and tardy way, and not in a timely, fashion.

Mr. Misheff writes that "almost every professional trustee trustee [*sic*] I am aware of is against the proposal (once they understand it)." I understand my co-reporter to say that almost every banker he speaks with is for the proposal, once it is explained.

Second subparagraph: The letter complains about a nebulous world. Trustees inevitably have discretion. They get paid to exercise their discretion. If a legislative solution is good for trust beneficiaries, and is required to allow UPIA to work, then it may be necessary to require some trustees, on some occasions, to exercise additional discretion. It is expectable that the job of being a trustee will become more complex as we enter a new millennium. Bankers have to be willing to deal with complexity.

Third subparagraph: The standards are initially from the UPIA and ultimately from the law of trusts. They are clear.

Fourth subparagraph, on page 16: UPIA has opened whatever battle grounds may come to exist. When the family bought the car (UPIA) it made the decision to buy the spare tire and the jack (Section 104).

CALIFORNIA MUST HAVE A WAY TO DEAL WITH THE UPIA PORTFOLIO THAT IS UNDERPRODUCTIVE. There is a train coming down the track, whether the bankers hear it or not.

Fifth subparagraph, on page 16: Mr. Misheff complains of increased costs and the like. The increase in costs is inevitable -- it comes from Modern Portfolio Theory investing. Inadequate traditional income is an inevitable cost of MPT investing for some trustees. That cost is likely to be much less than feared.

Sixth subparagraph, on page 16: A large number of trusts are still drafted on the basis of income to A, remainder to B, with no power of invasion for the income beneficiary. Although the drafter of the letter didn't mean to, he makes the case for the very dramatic change, that is being proposed elsewhere, of making every trust a discretionary trust. That more dramatic proposal, is the kind of solution that makes the "Goldilocks" solution of Section 104 all the more attractive.

Thank you.

Sincerely,

Joel C. Dobris

Joel C. Dobris
Professor of Law
Telephone 530 752 1600
Fax 530 752 4704
email: jcdobris@ucdavis.edu

c:\word\prininc\corres\lawrvn1

MEMORANDUM

TO: CALIFORNIA LAW REVISION COMMISSION
FROM: EXECUTIVE COMMITTEE OF THE ESTATE PLANNING, TRUST, AND PROBATE LAW SECTION OF THE CALIFORNIA STATE BAR ASSOCIATION
DATE: MARCH 17, 1998
RE: **COMMENTS ON SELECTED PORTIONS OF THE UNIFORM PRINCIPAL AND INCOME ACT (1997)**
CC: BION GREGORY, NCCUSL
MATTHEW S. RAE, JR., NCCUSL
MAUREEN PADDEN, CBA
DAVID C. LONG, STATE BAR
ROBERT E. TEMMERMAN, JR.

The Executive Committee of the Estate Planning, Trust, and Probate Law Section of the State Bar assigned the Uniform Principal and Income Act (1997) to a subcommittee of six for review. The subcommittee members each undertook a review of one or more articles of the Act. While I have not yet received comments from all of my committee members, I want to get those comments I do have into your hands without delay. I will submit our comments on the balance of the Act as soon as I receive them.

The Executive Committee as a whole intends to discuss the Act at its annual meeting in mid-April but has not yet had an opportunity to review and comment upon this memorandum. We are submitting our preliminary comments at this time at the request of the CLRC in order to assist its deliberations at its March meeting.

Article 1
Definitions and Fiduciary Duties

Section 102. Definitions

1. The definition of "fiduciary" in Probate Code section 39 is broader, encompassing guardians, conservators, and "other legal representatives" as well as personal representatives and

trustees. Presumably the Act is not intended to apply to conservators, guardians, custodians, attorneys in fact, and others besides trustees and personal representatives who have fiduciary duties of any kind whatsoever; thus, the definition in the Act is appropriate. However, the definition should make clear that it applies for purposes of this chapter only and applies notwithstanding any other definition found elsewhere in the Probate Code. This comment applies to all terms that are also defined elsewhere in the Probate Code.

2. The term “principal” appears to be too limited in that principal may be distributed to remainder beneficiaries during the trust term as well as upon termination of the trust.

3. The term “remainder beneficiary” may also be too limited, again because principal may under some circumstances be distributed to remainder beneficiaries during the trust term.

4. The definition of “terms of a trust” is elegant but likely to confuse. If we intend to have the Act apply to oral trusts as well as written trusts, perhaps we should just say so with the qualification that an oral trust must be susceptible of proof according to the usual evidentiary rules. The current wording of this definition suggests that the usual parole evidence rules will be relaxed, with regard to written trusts as well as oral trusts.

Section 103. Fiduciary Duties; General Principles

Section 103 appears to adequately encompass the essential provisions of Probate Code section 16302. The Act does not restate current section 16302(b), which provides that where a trustee has discretion to allocate receipts and disbursements between income and principal, no inference of impropriety arises from the fact that the trustee has made an allocation contrary to the provisions of the principal and income law. Instead, the Act contains a provision that a fiduciary, in allocating receipts and disbursement between principal and income, may exercise a discretionary power granted to the trustee, even if the exercise of the power produces a result different from a result required or permitted by the Act. The proposed new provision probably has the same exculpatory effect as the existing provision, but we prefer the existing language.

The rule of Section 103(a)(4), which allocates or charges to principal any item that is not covered by either the terms of the trust or the Act, is not found in existing law and should prove useful.

Section 104. Trustee’s Power to Adjust

Granting the trustee a power to adjust between income and principal is appealing in theory. However, we see numerous problems with the Act in practice:

1. Adjusting total return between principal and income clearly and directly affects the interests of beneficiaries and necessarily favors one class of beneficiaries at the expense of another. Increased discretion with respect to such decisions will expose the trustee to correspondingly greater scrutiny and criticism. Our primary concern about this proposed rule is that it will expose trustees to additional claims and give rise to more litigation in a field where litigation is already burgeoning.

a. The greatest hazard for a trustee in utilizing the proposed adjustment rule is presented by the requirement that the trustee “consider all factors relevant to the trust and its beneficiaries” and the inclusion in the Act of an extensive (although not exclusive) list of specific factors that must be considered in making the adjustment. A trustee’s consideration of each and every one of the enumerated factors is mandatory rather than discretionary. This nine-factor list would provide the plaintiffs’ bar with a convenient guide in deposing trustee defendants. A trustee who cannot demonstrate that it has considered each of these factors will be in violation of the Act and potentially liable for damages.

b. The requirement that the trustee consider all factors relevant to the trust and its beneficiaries applies not only to the decision *how* to adjust; it also applies to the decision *whether* to exercise the power to adjust. This provision, found in the first sentence of Section 104(b), suggests that the power to adjust granted in subsection (a) may not be as permissive as it first appears. A trustee who declines to make an equitable adjustment may be forced to justify its decision by demonstrating its analysis of the nine factors (and more) mandated by subsection (b). Arguably, a trustee who invests for total return without adjusting the return between income and principal interests is already exposed to criticism under existing law and could be held liable for breach of the duty of impartiality. However, the failure to make an equitable adjustment will be more clearly actionable if we have a law that so explicitly describes how a trustee should make the decision. While the last sentence of Section 103 states that "[a] determination in accordance with this [Act] is presumed to be fair and reasonable to all of the beneficiaries", a determination *not* to make an adjustment will be harder to defend under the Act than under current law.

c. The trustee will often have difficulty marshaling reliable information as to a few of the factors listed in Section 104(b), such as the intent of the settlor, the circumstances of the beneficiaries, the "actual and anticipated effect of economic conditions" and the "effects of inflation or deflation". Some of these factors will necessarily be somewhat vague and conjectural.

d. Examples (4) and (5) in the NCCUSL comments to Section 104 illustrate the potential complexity of the analysis required of the trustee.

2. Given the complexity of the decisionmaking process, a trustee would be foolhardy to make an adjustment without the protection of a court order or the informed consent of all beneficiaries.

a. A trustee seeking a court order will presumably have to demonstrate in its pleadings that it considered and analyzed each element of Section 104(b), as well as any other relevant factors. A non-institutional trustee cannot reasonably be expected to engage in such analysis and will need expert help. The result will be a substantial increase in administration costs. The need for expert testimony will also make litigation on these issues more expensive and time-consuming than it would be otherwise.

b. A trustee will (or should) be reluctant to rely on the consent of beneficiaries for self-protection when making an adjustment, because few beneficiaries will be able to understand the complex decisionmaking matrix, thus precluding "informed" consent.

3. If a trustee chooses to make an equitable adjustment, can the adjustment be made on a one-time basis, or must a similar adjustment be maintained in the future? For example, if a trustee makes one adjustment to enable the income beneficiary to receive the equivalent of a 7% return, and the next year the trust's accounting income is 5%, will the trustee be bound to make another adjustment to bring the income return to 7% for that year as well? Even if the trustee is not

technically bound to make such an adjustment in year two, will he be open to criticism by the income beneficiary for his failure to do so? ("If it made sense last year, why doesn't it make sense this year?") If such continuing adjustments are required, how often must they be made?

4. Section 104(c)(8) prohibits a trustee from making an adjustment if the adjustment would benefit the trustee directly or indirectly. Any adjustment that has the effect of shifting return from income to principal would indirectly benefit the trustee whenever trustee fees are computed as a function of principal value. Although less likely, the same problem could arise where trustee fees are a function of trust income and the adjustment shifts return from principal to income.

5. The adjustment provisions of the Act would not apply to many (perhaps most) trusts. The Act itself specifically excludes all marital deduction trusts, virtually all charitable trusts, all grantor retained unitrusts and annuity trusts, those grantor retained income trusts that are not subject to the Chapter 14 rules of the Internal Revenue Code, and most bypass trusts (also referred to as exemption trusts or credit shelter trusts). Also excluded, as a practical matter, will be those trusts drafted after adoption of the Prudent Investor Act that avoid reference to the trust's "income" in describing the amount to be distributed to the beneficiaries.

a. On the one hand, the limited applicability of Section 104 will limit the scope of the potential problems noted above. On the other hand, its limited applicability makes its adoption as a default rule less justifiable.

b. Section 104 should not be foisted on the trusts and estates community as a default rule. The law should merely permit trustees to obtain a court order for adjustment of total return between principal and income where, in the trustee's judgment, such adjustment is necessary to avoid inequity. While such a proposal seems to run contrary to the trend of reducing court involvement in trust and estate administration, it would actually result in less court involvement than Section 104 would spawn. This is one area in which we will not do trustees - or beneficiaries - any favors by giving trustees more discretion.

6. There is always a tension in lawmaking between simplicity and equity. Existing law may be inadequate to deal with the new investment standards of the Prudent Investor Rule, but it has the virtue of being relatively simple, and it can be understood by a broad range of trustees and beneficiaries.

Section 104 swings to the other extreme and creates a procedure that, at least theoretically, allows for greater fairness but is unduly sophisticated to serve as a default rule. The administrative burden, cost, and litigation risk posed by the rule are unacceptable. We recommend a truly optional procedure that will enable the trustee to avoid the sort of unfairness that breaches its duty of impartiality but will not create an unreasonably high standard that exposes trustees to undue risk of liability.

Finally, if this version of RUPIA or a later draft of RUPIA is adopted, some further consideration must be given to protection or exoneration for a trustee who acts in good faith. In our view, it is desirable in many cases to give trustees more discretion to make adjustments. The traditional notions of income and principal do not work well in today's economic and market environment and income and principal definitions may be antiquated. On the other hand, the more discretion, the more difficult the trustee's job may be and inevitably, trustees will be exposed to more litigation by disgruntled beneficiaries. No one will be happy. A situation in which a trustee will be forced to go to court for every discretionary decision or will have to incur significantly greater administrative costs to carry out the new law may be counterproductive. We cannot rely on every drafter to "draft around" the new law nor is it desirable to always do so.

At a minimum, a provision similar to Probate Code Section 16302(b) should be included to protect a trustee who makes a decision contrary to the new law. This is not found in RUPIA at least to the extent of my review to date.

Article 2
Decedent's Estate or Terminating Income Interest

Section 201: Determination and Distribution of Net Income (corresponds to Probate Code Sections 16305 and 16314)

1. Section 201 deals with the Determination and Distribution of Net Income in the case of an estate after a decedent dies or after an income interest in a trust ends. The section speaks in terms of "net income" and "net principal." Terms including use of the word "net" are not generally not used or defined in the current California Act. Collaterally, the term "net income " is used, but not defined, in Probate Code Section 12006. Section 108(8) of RUPIA defines the term "net

income”; it also uses, but does not define, the word “net principal.” I think RUPIA should define the term “net principal.” The definition is not obvious. In addition, Section 201 uses the term “terminating income interest” which is also not defined in the definitions section although it is defined in the Comments to Section 201. Because there are many new and unfamiliar terms in RUPIA, it seems to me these terms should all be defined in Section 102.

2. Section 201(1) provides that the fiduciary will distribute net income and net principal receipts to a beneficiary who is to receive specifically devised property. This section then sets out rules for determining the remaining net income of an estate or terminating income interest and cross references Articles 3 through 5. Articles 3-5 are basically the remaining provisions of RUPIA dealing with apportionment at the beginning and end of an income interest, and allocation of receipts and disbursements during administration of a trust.

3. Section 201(2)(B) changes the rules for payment of expenses. The fiduciary has discretion to pay from income or principal the following expenses: attorneys’ fees, accounting fees, fiduciary fees, court costs and other expenses of administration and interest on death taxes. However, the fiduciary may only pay these expenses “from income of property passing to a trust” [reason for quotes noted below] for which the fiduciary may claim an estate tax marital or charitable deduction to the extent that payment of those expenses from income will not cause a reduction or loss of the deduction. The Comments to Section 201 refer to the Supreme Court decision in the Hubert case. In Hubert, the Court held that an estate was not required to reduce its marital and charitable deductions by the amount of administration expenses that were paid out of income generated during administration by assets allocated to a marital and a charitable trust. The Court found that the value of the transferred property is not reduced for estate tax purposes unless the administration expenses were “material” in light of the income the trust corpus would have been expected to generate. The IRS is currently reviewing the issue of materiality and will undoubtedly issue new Regulations which will set limits on the amount of expenses payable from income. This new provision is an improvement because it gives the trustee the discretion to decide where these expenses might best be paid. Under the current California apportionment statutes, it could be argued there is room for equitable adjustment (Probate Code Section 20112(c)) although under somewhat unusual circumstances, in Simpson v. White, 97 Daily Journal DAR 11843 (Sept. 11, 1997), the Court held that interest on delinquent

death taxes was charged to principal. The new RUPIA provision is desirable in our view.

Under Section 501(3) of RUPIA, interest on death taxes would be paid from income “except as provided in Section 201(2)(b) or (c).” This example illustrates the interrelationship between Section 201 and Sections_501 and 502. It is somewhat confusing. My interpretation is that a trustee’s discretion under Section 201 overrides the provisions of Sections 501 and 502 which state the general rules.

All other disbursements relating to settlement of a decedent’s estate or winding up of a trust, including debts, funeral and burial expenses, family allowances, death taxes and penalties are paid from principal and are apportioned to the estate or to the terminating trust income interest either by the will, the terms of the trust or by applicable law.

With reference to Section 201(2)(B), we are uncertain as to why the reference to paying expenses from income is only to property “passing to a trust” and why the reference is not simply to property for which a fiduciary claims a marital or charitable deduction. Does it make a difference whether the property is passing outright or to a trust? It seems to us that the same principle should apply to income earned by an asset which will be distributed outright after administration as well as to an assets which will pass into a trust.

4. Section 201(3) relates to payment of interest on an outright pecuniary devise, whether provided for by will or trust. If the document does not provide for interest to be paid, interest will be paid as provided by law and will be paid from net income (as otherwise determined under Section 201) or from principal if net income is insufficient. The intent is to put pecuniary devises from inter vivos transfers on the same footing as testamentary transfers. However, the RUPIA Comment to this provision states that an outright pecuniary bequest is to be treated differently than a pecuniary bequest in trust. The Comment goes on to state this is the same treatment as provided in Section 5(b)(2) of the 1962 Act. California Probate Code Section 16314 refers to gifts bearing interest and also puts inter vivos transfers on the same footing as testamentary transfers. Section 16314 refers to “a specific gift, a general pecuniary gift, an annuity, or a gift for maintenance distributable under a trust.” Our interpretation of California law is that outright gifts and pecuniary devises in trust are treated the same. This seems desirable and should continue. Apparently, under RUPIA, a pecuniary devise in trust is entitled

to receive net income (see 5 below) but is not entitled to interest.

Section 16314(b) contains a provision for a reference date for when payment of interest will commence. Section 201(3) should provide that interest shall be payable as of the date of death or other event upon which the beneficiary’s right to receive the pecuniary amount occurs.

5. Section 201(4) states that the fiduciary shall then distribute the net income remaining after the distributions required by Paragraph (3) to all other beneficiaries (including a beneficiary who receives a pecuniary amount in trust). We believe that distributions under Paragraph (1), in addition to Paragraph (3), should also be excluded. Section 201(1) refers to specific devises. The beneficiary who receives a specific devise is already entitled to receive the net income and net principal of the specific devise. That beneficiary should not be further entitled to receive net income from other distributions.

6. Section 201(4) also states that a beneficiary who receives a pecuniary amount in trust is entitled to receive a portion of the net income remaining for distribution even if that beneficiary holds an unqualified power to withdraw or other presently exercisable general power of appointment. We do not know of any specific provision in the Probate Code which deals with this particular circumstance. It is not objectionable.

7. Section 201(5) is confusing. Our reading of Subsection (5) is that the fiduciary may not charge general administration expenses which relate to the estate or trust as a whole against the principal and income receipts of specifically devised property. It is not clear how to apply this Section. Subsection (5) states that the fiduciary may not reduce principal or income receipts from specifically devised property because of “a payment described in Section 501 or 502” to the extent that the document or the law requires the fiduciary to make payment from assets other than the specifically devised property or to the extent the fiduciary recovers or expects to recover the payment from a third party. The section goes on to state that the net income and principal receipts of the specifically devised property are determined by including all of the amounts the fiduciary receives or pays with respect to the property, regardless of when these amounts accrue or become due. Our understanding as to specifically devised property is that it is entitled to receive its income but it is also charged with specific expenses. For example, if there is a devise of real

estate, that real estate will receive its rental income but will be charged with mortgage payments, real property taxes, insurance premiums, etc., i.e., any expenses which specifically relate to that property. In this example, the property would, however, not be charged with general administration expenses such as attorney or trustee fees, etc. This may be what Section 201(5) is stating but we find the language confusing. There is no explanation in the Comments to Section 201.

Section 202: Distribution to Residuary and Remainder Beneficiaries.

1. We do not find any specific correlation in the current California Act to Section 202. This section provides that each beneficiary is entitled to a fractional interest of the net income which is proportional to the beneficiary's fractional interest in undistributed principal assets, using values as of the distribution date. This is a useful provision and makes explicit the method of computing the residuary beneficiary's interest in the remaining net income during estate or trust administration.

2. Section 201(a) states that each beneficiary described in Section 201(4) is a person entitled to receive a portion of the net income, presumably as a residuary beneficiary. Again, as noted in paragraph 5 above, relating to Section 201(4), we believe Section 201(4) must specifically exclude a person who receives specifically devised property under Section 201(1).

3. In determining the value of undistributed principal assets at any time when a distribution is to be made, the fiduciary is to include assets even though they may later be sold to meet principal obligations. This seems acceptable.

4. Each beneficiary's fractional interest in undistributed principal assets is calculated without regard to property which is specifically devised or to outright pecuniary gifts. This also seems acceptable.

5. Section 202(b)(4) allows the fiduciary to calculate the value of the assets as of the date "reasonably near" to the date on which actual distribution will be made. We believe that a date "reasonably near" is satisfactory and practical from an administrative point of view.

6. Section 202 changes the basis for calculating the fractional interest of the residuary beneficiaries and the net income from inventory values to value of the assets as of a date

reasonably near the date of distribution, as mentioned above. This seems a fair rule. It will, however, require the fiduciary to revalue the assets each time a distribution is to be made and will require appraisals or other valuation methods which may increase the cost of administration.

7. Section 202 also permits (but does not require) the extension of these rules for distribution of net income to residuary beneficiaries to gain and loss from the disposition of assets during administration. This was not provided for in the 1962 Act and had been commented upon as desirable by several noted commentators. This is not specifically found in the California Act.

8. As a minor note, it appears that in Section 202(c) the reference on line 2 to "person" should be a reference to "beneficiary."

Article 3

Apportionment at Beginning and End of Income Interest

Section 301. When Right to Income Begins and Ends

1. Section 301 defines when an income interest begins and ends. It draws upon existing references in the 1962 Act, as contained primarily in existing California Probate Code Section 16304(a), and expands upon them and clarifies them. The existing references to the beginning of an income interest appear almost as incidental references incorporated in the Section 16304(a) language dealing with the apportionment of those interests. The removal of that language to this separate section, separated from the intricate apportionment language itself, has given the Drafting Committee the opportunity to address in more detail the variety of ways in which an income interest may commence. This separate definition section has also given the Drafting Committee the opportunity to address explicitly when a income interest ends.

2. The introduction of a section which defines the beginning and end of an income interest helps clarify those references when they later appear in Sections 302 and 303 relating to the apportion of interests triggered by the events (defined in Section 301) which cause the beginning and end of an income interest.

Section 302. Apportionment of Receipts and Disbursements When Decedent Dies or Income Interest Begins

1. Having defined when an income interest begins in Section 301, the Drafting Committee has consolidated in this section the apportionment of receipts and disbursements when an income interest begins. This section applies a consistent treatment to similar transaction Under prior law, apportionment was sometimes different for essentially similar circumstances. For example, different rules applied to distributions arising from a probate administration than to similar distributions from a revocable trust. Transactions that are now essentially substantively the same are treated the same way for apportionment purposes. Given the substantial growth in non-probate dispositions of decedent's estates, it is both logical and preferable that disparate treatment for apportionment purposes be eliminated.

2. Under prior law, a periodic payment such as a dividend, an interest payment or rent payment received by a trustee following the death of the decedent was apportioned, with the pre-death portion of the receipt allocated to principal and the post-death portion allocated to income. With the thought that many beneficiaries, and particularly a surviving spouse, are dependent on a regular flow of income from periodic payments, this section provides that such periodic payments are not apportioned. In the vast majority of cases, we believe, this result is precisely what the decedent would have preferred and is an appropriate change.

Section 303. Apportionment When Income Interest Ends

1. Section 303 provides that collected but undistributed income on hand when the mandatory income interest ends is to be distributed to a mandatory income beneficiary or to his or her estate if the event of his or her death caused the termination of the mandatory income interest. This rule is consistent with prior law. Although the Drafting Committee determined that this result is probably inconsistent with what most settlors would prefer, the opposite rule would likely cause conflicts about whether the trustee acted appropriately in failing to distribute the undistributed income and, on balance, the Drafting Committee opted to maintain a rule that appears to minimize the conflict. This rule does not apply, however, to income or expense that is due or accrued but not yet received or expended, and such items continue to be apportioned. The Comment contains a helpful example as to how this section applies to accrued periodic payments.

2. The Drafting Committee has carved out an exception to the undistributed income rule. The exception requires undistributed income to be added to principal rather am distributed where the current income beneficiary had a power to revoke more than 5% of the trust immediately before the income interest ends. The presumption is that the current income beneficiary has had ample opportunity to provide for the distribution of undistributed income through the exercise of the power of revocation and, if he or she fails to do so, then the undistributed income should not be distributed to that beneficiary or his or her estate. The Comment contains a helpful example with respect to a trust over which the beneficiary had a partial power of revocation.

In conclusion, new Article 3 is preferable to prior law for the following reasons:

a. The subject matter is organized in a more logical manner.

b. Substantive inconsistencies under prior law are corrected.

c. The Article takes into account the broader range of testamentary and non-testamentary instruments now in use.

d. The Article provides clearer and more concise guidance to fiduciaries with respect to circumstances that are likely to arise with some frequency.

Article 4
Allocation of Receipts During Administration of Trust

We have no comments on Sections 401 through 407 at this time.

Section 409: Deferred Compensation, Annuities, and Similar Payments

Proposed Section 409 treats its subject (deferred compensation, etc.) far more extensively than existing Probate Section 16310. Contrary to the view expressed in the CBA's comments, Section 409 does not seem overly complicated, but rather provides rather straightforward and comprehensive (rather than the current cursory) guidance in dealing with payments received from deferred compensation and other similar arrangements.

Section 410: Liquidating Assets

Section 410 replaces existing Probate Code Section 16310 (entitled “Distribution from Property Subject to Depletion”). Existing Probate Code Section 16310 vests a trustee with discretion to allocate a receipt subject to the section's coverage to income or principal, “but in no event shall the amount allocated to principal exceed a reasonable allowance for depletion or amortization.” Proposed Section 410 installs a fixed standard, under which all subject receipts are allocated 10% to income and the balance to principal. The RUPIA approach certainly is simple to understand and administer, and seems reasonable in concept, particularly remembering that Section 104 authorizes adjustments between principal and income if circumstances warrant.

Sections 411 and 412: Minerals, Water, and Other Natural Resources/Timber

Sections 411 and 412 set forth a more structured approach to allocating receipts from exploitation of natural resources than that found in the existing provisions of the California Probate Code.

With respect to proposed Sections 409 through 414, the CBA Comments observe generally that principal is favored over income. This certainly is true, but, of course, must be considered in light of the fact that Section 104 authorizes reallocations of principal and income when circumstances warrant.

Section 413: Property not Productive of Income.

RUPIA eliminates the concept of “underproductive property”, presently covered under Probate Code Section 16311. Accordingly, under proposed Section 413, all proceeds from the sale of an asset are principal, irrespective of how much income was produced from the asset at any time. This approach makes sense, of course, only if Section 104 is enacted, thus vesting the trustee with discretion to allocate a portion of the proceeds of sale to income if circumstances warrant. If Section 104 is not enacted, then perhaps something like existing Probate Code Section 16311 should remain in effect, although the test for "how low must the income be to be inadequate" should not be applied on an asset by asset basis, but rather in relation to the entire portfolio (as is consistent with the Uniform Prudent Investor Act).

Section 414: Derivatives and Options.
Section 415: Asset-Backed Securities.

These two sections address financial instruments of recent vintage, and provide straightforward guidance for allocating receipts within the scope of their coverage. Both sections seem well conceived and worthy of adoption.

Article 5
Allocation of Disbursement During Administration of Trust

Section 501: Disbursements of Income

1. Section 501(2) charges half of all expenses for all accountings to income. Since there are situations where it would be more equitable to charge income (or principal) the full amount of accounting costs, *e.g.*, where a non-periodic accounting is brought at the request of only income beneficiary, the draft should adopt a modified "California" approach (since California gives a court the power to override the statute) so that the court is able "to direct otherwise" as to all expenses (not just the expenses discussed here). This would give the court the discretion to override splitting accounting expenses between income and principal equally where this would be equitable.

2. Section 501(3) provides that all other ordinary expenses incurred with administration, management, and preservation of trust property are charged to income. This should be revised to split equally such charges between income and principal. This seems more appropriate because administration expenses also operate to preserve principal. However, in the case of a proceeding primarily concerning an income interest, the expenses should be charged entirely to income.

Section 502: Disbursements from Principal

1. Section 502(a)(4) provides that expenses of a proceeding that concerns primarily principal, including a proceeding to construe a trust, are charged entirely to principal. This should be revised to specify that in the limited case of a proceeding to construe a trust involving income, expenses should be charged entirely to income. For example, a court may be asked to construe an income sprinkling power. In addition, this provision and prior provisions of Section 501 should make clear that expenses of property rentals should be charged to income. Although this seems to be the approach of the draft, it should be made explicit.

2. Section 502(a)(7) provides that disbursements relating to environmental matters be charged all to principal. This should be revised to split the charge one half to income and one half to principal. These expenses could completely eliminate either the income or the principal interest if charged entirely to either. It seems more fair to charge these equally to the income and the principal interests.

We disagree with the comment by the California Banker's Association that Section 502(a)(7) should be incorporated into Section 16312(b) of the Probate Code, so that it provides disbursements related to environmental matters are allocable only to principal. As noted above, it seems more equitable to split disbursements relating to environmental matters equally between income and principal (subject, of course, to the court's discretion to override this allocation in appropriate cases).

Section 503: Transfers from Income to Principal for Deprection

1. Current California law allows a trustee to make allowances for depreciation on property subject to depreciation under Generally Accepted Accounting Principals ("GAAP"), extraordinary repairs or expenses incurred in making a capital improvement. Probate Code Section 16312(b)(2), (d)(3). Current California law that relies on GAAP principals is superior to this section of the draft RUPIA. Reliance on GAAP provides a trustee with a readily available guidance from a professional organization. This may also stifle any threats by the Internal Revenue Service that through such depreciation transfers, a sensitive trustee would have the power to change beneficial interests.

2. Section 503(b)(2) prohibits transferring cash receipts to principal for depreciation during the administration of a decedent's estate. If this prohibition is going to be included,

it should be limited to a reasonable period of time for the estate administration.

Section 504: Transfers from Income to Reimburse Principal

1. Section 504(b)(4) allows transfers from the income to the principal account in the case of 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. There is a potential problem here in the case of an asset that the trustee could mortgage after it has been significantly depreciated. This in effect would require the income beneficiary to "pay" for the depreciation twice. The full amount of the periodic payments (interest and principal) could be transferred from income to principal after the asset has be depreciated to zero. This transfer, therefore, should be limited to any interest payment.

2. Section 504(b)(5) allows transfers from income to principal in the case of disbursements related to environmental matters. As mentioned above, Section 502(a)(7) requires that these expenses be charged entirely to principal. Both sections should be modified to carry out the suggestion that environmental expenses should be split equally between income and principal.

Section 505: Income Taxes

No comments.

Section 506: Adjustments to Principal and Income Because of Taxes

1. Section 506(a) allows a fiduciary, in the fiduciary's discretion, to make adjustments between principal and income to offset the shifting of economic interests or tax benefits between income beneficiaries and remainder beneficiaries arising from tax elections, tax imposed on a fiduciary or beneficiary, and the ownership of interests in entities producing taxable income. The use of this permissive, rather than a mandatory, approach, particularly where the trustee is allowed to compensate for shifting of "economic interests" as well tax benefits, may invite IRS challenge where a sensitive trustee is involved. Treasury Regulations Section 20.2041-1(b) provides that the fiduciary power of management does not amount to a general power of appointment, but the regulation specifies that this is where the power is "exercisable in a fiduciary capacity, whereby the holder has no power to enlarge or shift any of the beneficial interests therein except as an incidental consequence

of the discharge of such fiduciary duties.” Requiring equitable adjustments would be safer than using the permissible language.