

Study L-649

March 18, 1998

Third Supplement to Memorandum 98-19**Uniform Principal and Income Act: Preliminary Considerations
(Letter from Prof. Kasner)**

Attached to this supplement is a letter from Professor Jerry A. Kasner opposing the Uniform Principal and Income Act, primarily the adjustment power in Section 104. Prof. Kasner's main concern has to do with the impact of the UPAIA on individual, noninstitutional trustees, particularly in light of the retroactive application of the Act. He believes other provisions in the Act are excellent.

Respectfully submitted,

Stan Ulrich
Assistant Executive Secretary



SANTA CLARA UNIVERSITY

SCHOOL OF LAW

March 17, 1998

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

Law Revision Commission
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Re: Uniform Principal and Income Act

File: _____

Ladies and Gentlemen:

The purpose of this letter is to register opposition to adoption of the latest revision of the principal and income law in the strongest possible terms.

My main complaint is Section 104, granting a trustee power to adjust income and principal under Sections 104 and 103(b). The main addition I would make to the adverse comments you have already received is that they are not strong enough. Most have come from corporate fiduciaries. The impact of this new law on personal trustees is, in my opinion, catastrophic.

The effect of Section 104 is to retroactively convert all trusts into discretionary trusts, regardless of the intent of the parties. It places interested trustees (i.e., trustees who have a direct beneficial interest in the trust, or whose family members have such an interest) in an almost impossible position. The only reasonable means of protection for any trustee is to seek instructions as to any distributions which are not specifically provided under the terms of the trust. Note the language in Section 104 that prohibits adjustments where the trustee will benefit "directly or indirectly". How in the world is that to be interpreted?

If the trustee has a power or direction to distribute income, the trustee is subject to objections if the trustee distributes: 1) only trust accounting income, 2) an amount in excess of trust accounting income, or 3) an amount less than trust accounting income. Further, if the trustee has a power to invade principal for the beneficiary, the trustee must take that into consideration in making the adjustment. Given the duty of impartiality and the fiduciary standards in the act, how can any trustee safely proceed without court approval?

Frequently, trust beneficiaries are given powers of invasion. In some cases, these are limited by ascertainable standards. In others, they may be based on percentage of the value of the trust, as the so-called "5 by 5" invasion power. How does this affect the adjustment power?


The Act also attempts to avoid possible federal income and transfer tax problems, and I am aware of comments that the IRS has "signed off" on this provision. While I have great admiration and respect for all the parties involved in this project, I prefer statements of the IRS position to come from the IRS, and in a form that is binding on the IRS. What appears in chat rooms on the Internet does not meet that standard.

Even assuming the conditions in Section 104 will avoid tax issues, the practical effect is to create a double standard of trust administration. Where the trustee is independent, the adjustment clause will be fully operational. Where the trustee is an interested party, and there are tax consideration, the trustee will be unable to exercise the adjustment provisions. Should the law really apply two different rules of trust administration, depending on the identity of the trustee?

The Prudent Investor Act is clearly a positive step in bringing trust administration into the modern world. However, the proponents are so zealous, they may forget the lessons of history. I have a little knowledge the efficient market theory, and the issues of inflation, and all of the other economic theories that support the Prudent Investor Act. I do not represent I am any kind of an expert. However, I do know that once principal (I prefer to call it capital) is distributed to trust beneficiaries under Section 104, it is no longer around to invest and grow. I also think, believe it or not, that it is possible to have a recession, maybe more than one, and for the market to go down. I do not believe prudent investing was intended to eliminate capital preservation, and my guess is that many remainder beneficiaries of long term trusts would agree.

Most of the other provisions of this revision are excellent, and the Committee should be commended. with a few changes, it will function quite well without Section 104. Please get rid of it.

Sincerely,


Jerry A. Kasner